PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

August 20, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 20, 1985, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Balles
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Mr. Guffey, Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, 1/ General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Broaddus, R. Davis, Lindsey, Prell, Scheld, and Siegman, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

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1/ Entered the meeting after action to approve minutes for the July meeting.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Jack Guynn, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Balbach, T. Davis, and Lang, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, and Philadelphia, respectively

Messrs. McNees, Miller, Pearce, and Beebe, Vice Presidents, Federal Reserve Banks of Boston, Minneapolis, Dallas, and San Francisco, respectively

Mr. Stevens, Assistant Vice President, Federal Reserve Bank of Cleveland

Ms. Meulendyke, Manager, Securities Department, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
August 20, 1985

CHAIRMAN VOLCKER. We need to approve the minutes of the last meeting. [Secretary's Note: Approved without objection.]

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Comments or questions?

MR. WALLICH. The drop that you described, which goes back to the peak, has been quite substantial--I think 20 percent against the mark and 16 percent [overall]. Do people regard that as a very rapid slide in the market?

MR. CROSS. Well, I don't think it has been a dramatic slide. It has been on average about 17 percent or so, and against the European currencies it has been more than that. So, it is certainly enough of a decline in the period of six months or less that it has attracted attention. It seems that the dollar has made this rather substantial adjustment, but I don't think there is a lot of expectation that it is necessarily going to fall off the table. Certainly, there is a generally bearish tone to the dollar and to the market's attitude toward it. And to the extent that these things can be generalized, there seems to be an expectation of possible continuing softness unless our economy changes.

MR. MARTIN. You put quite a bit of emphasis on the Treasury refunding as an indicator that foreigners, including the Japanese, are not going to rush to sell their U.S. securities. I am not quarreling with that implication of your comment, but can you broaden that analysis a little? Are foreigners tending to shorten their maturities as they roll securities over? What kinds of, for want of a better term, leading financial indicators are we getting out of the Euromarkets with regard to holdings of dollar-denominated versus otherwise denominated securities--these securities, whatever you call them, on which the interest is paid in one currency and the principal in another? Can you expand on that a bit?

MR. CROSS. Well, it is difficult to say very much because we really don't have enough information. Before the last refunding, which of course was a substantial one, there had been concerns expressed that [foreign investors] might stay away from that particular operation and that it would be in difficulty as a result. That didn't seem to happen. It was more the case of a nonbarking dog.

MR. MARTIN. But of course we didn't have a special offering to foreigners either, right?

MR. CROSS. That is correct. What we do know--or what we see and hear about--is that the Japanese, at least beginning in June, have tended to start doing more hedging. They continue to have substantial long-term outflows into dollars and U.S. securities, but they have tended, for I think the first time, to be doing more hedging. Also, we hear at least anecdotally, but it is very difficult to know how much attention to pay to these things, that one of the factors that has tended to keep sterling somewhat strong has been the tendency of investors to diversify a little toward sterling, which has been paying very high interest rates. But these [reports] are anecdotal; you can't really get a very sound understanding of something as large and as complicated as this market on the basis of a relatively small number of conversations and what you hear.

MR. MARTIN. Not even a shortening in maturities?

MR. STERNLIGHT. I could add a little comment on that too, Governor Martin. What we are hearing anecdotally also suggests a lesser pace of foreign buying, but continuing interest in the intermediate and long-term area. I don't get any sense, particularly from the dealers who have active Japanese operations, of a shortening of maturities. They are taking a little less but are continuing to look at the 10-year and longer area.

MR. WALLICH. If I may comment on this: The idea of shortening [maturities] is that they are more liquid and investors can get out more rapidly, which is a concern. But the investors who believe that they can ride out a substantial fall of the dollar presumably look at the long end and they probably would be right.

MR. PARTEE. Sam, the price of gold has increased significantly over this period that you are talking about too--that is to say, the dollar has dropped relative to gold. Gold wouldn't have changed much in price in terms of marks or Swiss francs, I don't suppose. Is that all that is being reflected here: that the market is made in Switzerland and Germany? Or do you think there is something else behind this move in gold?

MR. CROSS. Well, I think the interesting thing about gold is that the price has risen somewhat as the dollar has weakened, as you suggested, but it hasn't risen all that much. And in terms of the Swiss franc, it has been reasonably stable.

MR. PARTEE. Yes, I think that is probably right.

MR. CROSS. One of the interesting things has been that the difficulties in South Africa do not seem to have caused a greater increase in the price of gold. Now, there are all kinds of questions about that. There is a feeling that substantial supplies are being withheld from the market by the main producers, the South Africans and the Russians in particular. As the price moves up, then they tend to sell a little more and then it goes back down again. That seems to have been the pattern. One might have thought, with the concerns in South Africa and the possibility being talked about of mining strikes and other potential supply disruptions, that the price might have risen more than it has. It's now about $336 today, and that's not up all that much from where it was before so much attention was being paid to this. What has happened is that the price of platinum has gone up. I gather that South Africa is more critical to the platinum market than to the gold market, and platinum has moved up much more rapidly. But gold in a sense has shown relatively less buoyancy, in light of all these factors, than one might have expected.

MR. PARTEE. I see.

CHAIRMAN VOLCKER. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions?

MR. FORRESTAL. Peter, was there any particular reaction to the Bank of America dividend action?

MR. STERNLIGHT. Well, we were following their funding operations closely on the heels of that, and they did experience a slight widening of spreads--maybe by 0.5 or something like that. It was not a big reaction. They have a quite liquid operation; they have an enormous local deposit base. They generally are sellers rather than buyers in the overnight fed funds market. They have had a little erosion of the commercial paper funding of the holding company but, based on our observations, I would say they are weathering it pretty well.

MR. GUFFEY. What are the current spreads on the Farm Credit Agency--?

MR. STERNLIGHT. The current spreads would range from about 5 to 15 basis points on maturities up to one year--and those had been just about even with Treasuries earlier--to maybe 40 or 50 basis points on some of the longer maturities, which earlier had spreads of maybe 20 to 25 basis points.

MR. KEEHN. Did they defer a long-term issue within the last week or so?

MR. STERNLIGHT. Not that I am aware of. I think the market is looking for them to announce a term issue within the next few weeks.

MR. MELZER. Peter, how would you characterize dealer positions right now?

MR. STERNLIGHT. Given all the hedges on positions that are taken these days, it has become very difficult to make sensible comments about where dealer positions are. My impression is that there has been a pretty good distribution from the refunding that was just paid for a few days ago. I'd say they are on the moderate side.

MR. WALLICH. Peter, you mentioned the Japanese firms. I have always felt quite strongly about national treatment but I see in the press a statement that Karl Otto Poehl made after the last Bundesbank meeting that he takes a very different line. He refers to Japanese firms that want to come into the German market to assume this lead role; [the German authorities] have told them "no" until something is worked out with German banks in Japan. That's just a sidelight on that.

MR. STERNLIGHT. Yes. I think in the UK also there has been more of an attitude of looking at it as reciprocal--looking for specific olive branches and reciprocity before Japanese firms are welcomed into the developing gilt market in London. We have been following the situation and I'm still collecting impressions of just what the situation is in Japan; but my impression so far is that at least a respectable number of U.S. firms--8 or 10 or something like that--have quite good access to Japanese investors, in terms of selling U.S. securities in the Japanese market.

MS. SEGER. Peter and I discussed this a little because I think this is a bigger issue than just the Open Market Desk in that how we deal with Japan has general public policy interest. We have so few levers to use on them, and people I know on Wall Street tell me [the playing field] is not even. Maybe it is in a narrow government dealer sense; I don't know. But certainly, looking at the financial markets across the board, we treat them a lot better in this country than they treat us. I think we ought to consider a lot more angles than whether or not the dealer in securities is well capitalized and does a big volume of business. I am a competitive person, and I think it is only fair that it go both ways.

CHAIRMAN VOLCKER. [If no one else has] any comments, we might as well turn to Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

MR. PARTEE. You depend on a levelling out of net imports to get this improvement in GNP?

MR. KICHLINE. That is right. Was that a question to me or to Ted?

MR. PARTEE. Well, you made the presentation.

MR. KICHLINE. Well, there are two parts that really are important. We have very clearly much slower growth in final sales; instead of numbers in the 5 percent area, we are talking about numbers much less than that--something in the 2-1/2 percent area. So we are talking about a substantial slowing. What is going to happen in this environment for us to get 3 percent growth is essentially that inventories are not negative--that they are basically a small contributor--and that the deterioration in the trade balance comes to a halt pretty quickly. Ted, maybe you want to talk a little about some of those numbers. Maybe not!

MR. TRUMAN. Maybe not! One contributing factor clearly is that there is going to be less demand here. That certainly will be one factor slowing down the rate of increase in imports. It is also true that the rest of the world, while not booming, will be growing somewhat faster than we will. We feel that the export level was depressed, perhaps somewhat artificially, in the second quarter and that it should pick up some. I think that we have put in a relatively conservative--well, maybe "agnostic" would be a better way of putting it--trajectory for non-oil imports. Those imports in real terms had been running somewhat higher than the historical relationships would predict. It is not clear to what extent that is associated with structural changes in the world economy or with responses to exchange rates, which are not picked up by historical relationships. As the dollar has declined, and assuming it will continue to decline somewhat, we have chosen not to reverse that. In that sense we have been agnostic. Now, you could also say that we have not been so pessimistic as to believe that the phenomenon is going to increase in magnitude. Basically what we have on the import side is that imports are being driven by the slower growth in the United States and the decline in the value of the dollar, some of which has occurred already but much of which--basically for the projection period--is ahead of us. It is clear that there is considerable uncertainty in these numbers, as Jim indicated and as we have indicated before, because among other things they have been bouncing around quite a lot. I certainly wouldn't rule out the possibility that imports in particular could rise substantially faster than we have forecast. In fact, we have the imports in real terms continuing to rise marginally through the early part of 1986. It is also true that if they did rise more rapidly, everything else including demand being the same, then production obviously would be lower. On the other hand, to the extent that we may have been too conservative or shouldn't have been agnostic, or to the extent that more push comes from the exchange rate than we have built into the forecast, things could go somewhat the other way. There is some potential possibility that a sharper decline in the dollar, or a faster response to that, could produce more in the way of a cutback earlier than we have put into the forecast. We don't have anything really happening until early 1986 in quantitative terms.

MR. PARTEE. You ordinarily would expect quite a lag.

MR. TRUMAN. Yes, but you get quantity effects that begin to show through within a quarter or so.

MR. PARTEE. Within a quarter?

MR. TRUMAN. Yes, but again, you have to go four quarters in order to get half of the effects and a couple of years before you get all of them. There is considerable difficulty in knowing how to interpret the first quarter phenomenon where the dollar went far up and came back down. How much in the way of imports were discouraged during that period or weren't discouraged during that period? That is one of the conundrums involved here. Should you throw out that exchange rate [move] as basically not affecting anybody's decisions? Or should you include it? If you include it, then you would say that you were going to have the lagged effect of the first quarter in some sense feeding on through the remainder of the year. Since we're forced to fall back on more or less historical relationships, we have built some of that in. I think we could argue that a conservative approach to putting the forecast together can be justified on a micro or disaggregated level to the extent that we have had and will continue to have higher imports of Japanese automobiles in this new full year and that will work somewhat in the other direction.

MR. PARTEE. If I might ask another question: Jim, what do you make of the fairly pervasive weakness in nonresidential indicators in the last couple of months? Contracts and most of the elements there have been off quite substantially.

MR. KICHLINE. As you know, in the office building area, we have been anticipating for a long time that it would slow down. That was the domestic [equivalent of the] exchange value of the dollar; it kept rising and we said it was supposed to go down. It has been going down now. If you look at construction put in place as well as contracts, as you noted, and permits, the whole ball of wax suggests that that indeed is slowing. Now, it slows rather slowly because of the fact that there is a long construction lead time. So it is not something that we think will collapse. The problem in that area is that other indicators of activity--even in industrial buildings, public utilities and so forth--give us a sense that basically it has been weakening. So, in this forecast we have small declines; they could be larger depending on the assumptions one wants to make. But throughout the forecast period we have some small declines. Now, I would note that some of these data are very volatile; we have been caught before where the numbers go down for two or three months and they snap back. But I think that the fundamentals in vacancy rates and other things would argue now that perhaps we are in a period where we should expect small declines in real terms. And that is what we have built in throughout the period.

MR. BOEHNE. The main case for getting 3 percent is that the leakages from the foreign sector and inventories don't leak as much. On the other hand, there is the consumer sector, which is 60 some percent of total final demand. And there are at least some hints--income not growing quite as fast, the debt problems, mortgage delinquencies up a touch--that maybe that will not go on as it has. There is nothing dramatic, but at least there are a few straws in the wind. In the housing area, as you rightfully pointed out, one would expect some sluggishness in the multifamily area. But in the single-family area, while you would expect a drop in mortgage rates to have some effect, I wonder if you would expect a drop to have the same effect in an era when most mortgages are at variable rates compared to an era when most were at fixed rates. I guess I would expect a drop in rates to have some positive impact on single-family housing starts [but] not be as much of a stimulus in this kind of environment. I would like for you to comment some on the downside risks, two of which I pointed out: the consumer side and single-family housing.

MR. KICHLINE. Well, I don't feel quite as nervous about personal consumption expenditures at the moment as you suggest, if our income is right--if we are generating enough income in other sectors--because I think we have basically fairly mild expectations for personal consumption expenditures. We have to get some monthly increases, however, to get the 3 percent. I think I pointed that out; it is not in the bag. What we are expecting is literally 1-1/2 to 2 percent annual rates of increase in personal consumption expenditures from now on over the balance of the forecast period. In the first half of the year we have seen 5-1/4 percent increases--just a surge. At that time the saving rate dropped and debt was being taken on in substantial volume. What we have here is essentially a fairly low saving rate, income growth just tracking along, and not really a bullish environment. But you can point to the negatives, and the debt side is certainly one. Income growth, I think, is a little risky; there is not a lot of income growth being generated and you don't have to have too much happening in other sectors to lead to slower growth. So, I don't view it as a big risk in that we really do have a much slower pace of consumer spending in store.

The housing area is one where we may have the lags wrong. In thinking back, we said some time ago that we had seen a drop of a couple of percentage points in mortgage interest rates and, given the lags, we ought to be seeing some pickup. And we just haven't. I think I would abandon that story about the time the August numbers come in. Basically, our notion was that this should have happened this summer and it just has not happened yet; if the August numbers come in [and don't show a pickup], I think I will conclude that we really have miscalculated what may be driving that. We have gone through fairly carefully our sense of what ought to be happening. There is an awful lot of anecdotal evidence floating around: mortgage loan applications are up; appraisers are very busy; and existing home sales have picked up. But new home sales haven't done anything. Single-family starts haven't done anything. We have gone through and identified some of the positives. With lower interest rates, mortgages are more affordable; the demographics are strong, and household formation is good. On the other side is an environment in which expectations of major capital appreciation are not there, probably; tightened mortgage underwriting standards may be doing something at the margin; and there is uncertainty over the tax treatment of interest and property tax deductions. How you slice that is very important. If we had put this forecast together today, we would have a lower housing start number and a little lower residential expenditures. Those data came in after we put the forecast together and were weaker than we had built in.

MR. MARTIN. Jim, let me address Ed's question in a little different way. I don't have any problems with what you said. But isn't it true that, as the housing market has matured, there has been a shift in the direction of fixed rate mortgage originations and away from adjustable rate mortgage originations? If you go back a few months and take out the spike in the fixed mortgage rate, you really have a decrease of 100 to 150 basis points in that rate; the shift has been to using fixed rate loans. If you go along that line then, the tightening of credit underwriting can offset 100 or 150 points; it can't offset 200 or 300 points, probably. Perhaps there has not been that much improvement at the point of sale fixed rate mortgage, [given] that no appreciation in the house is looked for. So, just to complicate it further--

MR. BOEHNE. You know too much about that market, Pres.

MR. PARTEE. Yesterday I was reading--I think a number of us received this--a letter from the home builders. They really had quite an upbeat letter this time on traffic in the subdivisions and on sales and the outlook for sales over the next six months. For them it was as optimistic as I have seen for a long time.

MR. KICHLINE. They also had one in June; it was sort of going off the charts in terms of single-family home builders' expectations. That fits with other evidence; I'm just saying that we don't see it yet in terms of starts having picked up.

MR. MARTIN. I never talk personalities but that is a Sumicrast survey of home builders and the Colton projection is still 1.6, 1.7 million. Let the record not show that.

MR. BALLES. Jim, now that we have a budget resolution of sorts, I am wondering what your analysis shows with respect to the revised deficit realistically interpreted for the coming fiscal year. How, if at all, would you change your forecast as a result of that Congressional action?

MR. KICHLINE. The differences from our earlier assumptions were really quite small. We had assumed a package of about $50 billion on our basis and we interpret what actually was accomplished and our reading of what likely will be done in the following steps to amount to $45 billion. It is really quite close; we have only adjusted a little for that. The way we come out, though, is much less optimistic than some. In part, we have a weaker forecast so that there is some [difference in the] economic assumptions and less revenue. But we also have felt that many of the actions require single-year appropriations bills and that they will be addressing this year-in and year-out. There clearly are pressures now in the farm area to overrun those targets. There are some phony things, but it is stripping away the phony things. It really does take persistent action. So, in the near term we are fairly close; where I think I would be much less optimistic is in year two and year three. There we have not gone through an explicit process, but of course the CBO recently came forth with some numbers and they were considerably higher by the time you get to the third year. The Congress used very optimistic assumptions and also assumed actions that appear to us rather difficult to undertake. So I think it is a story that may have to be revisited. Our [estimate] on their basis of the total deficit is about $191 billion for fiscal year 1986 in contrast to their assumed $175 billion or so. We are in the range of $15 to $18 billion higher than Congress would be.

CHAIRMAN VOLCKER. Mr. Axilrod.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Now it's all very clear!

MR. PARTEE. I didn't know he had stopped! Don't you have another paragraph?

MR. BALLES. Could we pursue this issue of a shift in the demand for money a little more, Steve? What is your best guess? Is there a shift going on? There is that possibility, as you talked about. If that is not it, what is causing the drop in velocity of M1?

MR. AXILROD. I think it is semantics as to whether you call it a shift or not. I suspect at the moment that there is a change simply in the distribution of savings flows. And it could have a relatively simple explanation. If time deposits that are now maturing were put in a year ago--we don't have adequate data on when they were put in--they were earning 10 percent. Now they are earning 7 or 7-1/2 percent; I have forgotten the exact rate. And people may just simply out of psychological disappointment say: "Well, I will just put my money in this account where I can get at it rapidly and maybe rates will be a little higher later. I am used to earning a higher rate." There may not be any actual sense of real uncertainty or doubts about the economy in that context. I tend to think something sort of simple like that may be occurring at this point. And there is no way that the models pick up something like that--whether you call it a wrong elasticity or a demand shift. The surveys of consumer confidence are not so weak as to make you think that people are making a big broad shift in their pattern of saving. I don't know whether that kind of money behavior will in the future lead to the kind of strength of GNP that these models--this rather simple look at lagged money versus GNP --would lead you to think. One would say "no"--that that kind of saving behavior doesn't necessarily entail strong growth.

MR. BALLES. Would it be fair to say, based on that explanation or view of yours, that we could at least expect this overshoot of M1 from our new midyear targets not to carry with it the usual inflationary implications that it might otherwise have?

MR. AXILROD. Well, I think it wouldn't so far. If you were to ask me after it had gone on for four to six months, I would have to say that I think there is enough in monetarism to say that the risk is very strong that it would. And I am not so sure that I wouldn't think that there is a little risk at this very moment.

MR. BALLES. That's the $64 question!

MR. MELZER. Steve, your projected money growth for August is 14.3 percent, which is [a month-end level of] about $602.8 billion and we are at $601.9 billion. What do you think the risk is in that forecast? Obviously, it implies very little additional money growth over the month of August.

MR. AXILROD. A drop from what we had assumed. Well, we are going to get some data very soon and it is hard to say before that; but I guess the risk is probably that August might be a little lower and September higher. That's how I would tend to guess it, but my instinct is that we could be there or a shade higher as of now. I don't expect any great weakness. This NOW account behavior seems to me a little difficult to explain. The rate spreads are widening and are making time deposits a little more attractive and market rates a little more attractive, so I expect some shifting away from that soon. It is hard to say exactly when that will occur, but that ought to occur. Whether it will occur now or in September or October is hard to say.

MR. MELZER. By the way, on your point about the psychology of single digit rates, my feeling would be that there is some validity to that--that people have a very hard time accepting committing their money over a longer term for less than 10 percent.

MR. WALLICH. If you did a survey of 40 banks with a large expansion in NOW accounts, you might stop those the way you stopped demand deposits in your surveys!

MR. AXILROD. We did the survey after the demand deposits stopped.

MR. BLACK. Are you suggesting that as a new control device?

MR. WALLICH. He seems to have discovered one.

MR. AXILROD. Old M1A, or old M1--currency and demand deposits--in July rose 3.3 percent, so it is much less. And if our projections are right for August--we still have [data for] less than half the month--it would be rising 5-3/4 percent. So it has dropped [from the rapid pace in the spring]. The quarterly average, given that and a very reasonable September, would be about 8 percent. It grew 6.8 percent in the first quarter and 8 percent in the second; and on a quarterly average basis it has [unintelligible].

CHAIRMAN VOLCKER. What has the old M1A done through this year so far?

MR. AXILROD. Well, it was 6.8 percent in the first quarter and 8 percent in the second quarter--a couple of points below current M1. But it is much more below in July and August; it is decelerating more at this moment. Old M1 was 13 percent in May and 18-1/2 percent in June.

MR. BLACK. Steve, some time back you were experimenting with the predictive qualities of M1A. Have you played around with that lately to see whether it has any promise?

MR. AXILROD. Well, I did for that paper that I sent to the Committee before the last meeting. I did it in an excessively simplified way and it did not look very much different one way or the other. That is the conclusion I drew from it. In another approach, looking at it since 1982--not using the sort of model that I used, but in a simple way just looking at lagged M1 and lagged M1-A versus GNP--the deviations between M1 and GNP and M1A and GNP favor M1. They are narrower in M1 than in M1A.

MR. MORRIS. I have a technical question, Steve. In the Bluebook you mentioned state and local government advance refunding borrowing. Are they included in the net debt number?

MR. PRELL. Yes.

MR. MORRIS. Isn't that double counting?

MR. PRELL. Well, it is one of many forms of double counting that are in practice unavoidable because there are many layerings of borrowing and lending in the accounts. They are included and they have been sizable this year.

MR. MORRIS. So, that is a fairly major factor inflating the debt number now.

MR. PRELL. There has been about $20 billion worth of refundings thus far this year.

MR. MORRIS. Since interest rates are down, what they do is fund municipal issues and invest the proceeds in government [securities] and pick up the differential. Or, I guess maybe the Treasury doesn't let them do that anymore.

MR. AXILROD. No, there is a special issue.

MR. STERNLIGHT. They usually have to take a special issue from the Treasury.

MR. PARTEE. Of course, a corporation can do the same thing and call it defeasance.

MR. MORRIS. Yes. So, I should think those should be netted out of the number.

CHAIRMAN VOLCKER. It is a little hard to know where to stop.

MR. PRELL. That is right.

MR. MORRIS. Presumably, we don't include bank liabilities and also include bank investments in short-term securities. So we have tried to net where we can. It seems to me that if we have an area where clearly we have double counting and can identify it, that it ought to be eliminated.

MR. AXILROD. I think we did mention it the year before last as one of the factors causing credit to be strong along with the mergers and the drop in equity.

CHAIRMAN VOLCKER. What does $20 billion amount to--1/4 of one percent?

MR. PRELL. Let's see. The [monthly] flow is about [$1700 million]; if it ran [$20] billion for the year, it would be about 1/2 of a percent.

MR. WALLICH. Did the lagged study that you did differentiate between the impact of M1 on inflation and on the real?

MR. AXILROD. No. I was just doing what some people do in town here. It was the short run, looking at M1 versus nominal GNP with various quarterly moving averages--3, 6, and 9 months. It was not a very scientific study of looking ahead through models. No, the price effect, we still think, would take longer; this was just to nominal GNP.

CHAIRMAN VOLCKER. All these charts here would suggest that we are about to launch into a sizable boom, if you believe that.

MR. PARTEE. In the third quarter; we're right there.

CHAIRMAN VOLCKER. Well, you could argue, depending upon what lag you put in, that it could be delayed to the fourth quarter.

MR. PARTEE. The question is: Does anybody see it?

CHAIRMAN VOLCKER. Well, that is the question that I raise.

MR. BLACK. I don't think that there is anything out there now, but I think it is going to be out there some time, with a later lag. In 1982-1983, velocity behaved very unusually and yet we had a very strong pickup in 1983 and nobody expected that. The only thing that predicted it was M1. So, I am a pragmatist, and my faith is being shaken to some extent, but I still believe I am going to be vindicated on that somewhere down the road. It would be very unusual if it didn't happen.

MR. MARTIN. Laffer says that's the first effective date of the supply-siders' tax cuts.

MR. BLACK. Well, I'll have to [unintelligible] and find when that went in. I don't remember exactly.

MR. MORRIS. The leading indicators showed a little firming pattern in May and June, but what sort of depressed me is that the

July numbers for the leading indicators that we have don't look all that great. They reflect a definite weakening from the May-June number.

CHAIRMAN VOLCKER. This is the figure that hasn't been published yet?

MR. MORRIS. No, I'm just looking at the individual [components that we have].

MR. BOEHNE. It seems to me that the only way that we could get a major increase in economic activity would be if suddenly there were a change in the trade account, and that just strikes me as being unrealistic. We already have gross national expenditures, if you look at it from the expenditure side, probably rising 4 to 5 percent; if you take out the leakages, you get down to this 2 percent. So unless one can say we are going to have a big turnaround in the trade accounts in the near-term horizon, it is awfully hard to say that we are going to have a major increase in economic activity.

CHAIRMAN VOLCKER. A characteristic of the forecast you alluded to earlier is that we are going to have--I hate to call it major--a significant change in the trade trend and a weakening of the gross national expenditures of some magnitude. That is what the forecast is anyway.

MR. BLACK. Lyle is already pumping us for information! He asked me last night if I thought we would still get 8 percent in the fourth quarter, and I told him that it might be as late as the first quarter before we got that.

MR. BOYKIN. There is not anything down our way that leads to a whole lot of optimism. Just about everything--

CHAIRMAN VOLCKER. Your directors don't seem to think so.

MR. BOYKIN. That's for sure. The major thing, of course, is uncertainty in energy. We talked about that. Texas A&M University is predicting a 40 percent drop in farm income for this year. The Bureau of Business Research at the University of Texas is saying that Texas is already in a recession. There are uncertainties developing. Our unemployment rate has matched the national average, which is not all that bad, but it is rather bad compared to what we are used to. The whole sense, in an anecdotal way, is for not very much--

CHAIRMAN VOLCKER. What is happening in the energy area? Is there anything new?

MR. BOYKIN. No, nothing that I am aware of, other than [lingering] concern and predictions, at least, of further softening in oil prices. I don't think we are hearing quite the same scary scenario of [a decline to] something less than $20 a barrel, but we still are expecting some further decline.

CHAIRMAN VOLCKER. Drilling activity is doing what?

MR. BOYKIN. The drilling activity is down. The rig count is down about 25 percent from what it was a year ago, I believe. It's approximately that in Texas.

MR. RICE. But isn't it up in the most recent period?

MR. BOYKIN. It's up slightly, but for the nation--

MR. RICE. Not for Texas?

MR. BOYKIN. For Texas--

MR. FORRESTAL. It's up slightly for Louisiana.

MR. BOYKIN. I was thinking we were still running about [the same as] last time, which was about 25 percent--

MR. RICE. I don't have any quarrel with the comparison to a year earlier, but I somehow got the impression that within the last couple of months the rig count had climbed.

MR. PARTEE. Well, that's a 25 percent drop from a pretty low number.

MR. BOYKIN. From a pretty low number, yes.

CHAIRMAN VOLCKER. Well, does anyone have a different economic outlook?

MR. AXILROD. If it were helpful, partly for purposes of understanding the process, I could offer a scenario coming off of this money supply that would lead to maybe not much increase in real GNP but more in nominal and prices. Assume a little further decline in interest rates, which probably would be needed to start it, and suppose the natural rate of unemployment is more like 7 to 7-1/4 percent and that the productivity growth over time isn't going to be much more than 1/2 to 1 percent--taking some extreme assumptions--and that the Committee makes a strong effort to have real GNP grow 2-1/2 to 3 percent in that environment. Assume further that foreign countries loosen up a bit--and interest rates have declined in a few. It may very well be under those circumstances that the present good behavior of wages would begin to unravel as people would have to bid a little harder to get some decent labor. Commodity prices around the world, instead of dropping, could begin rising a bit more and we could get some rise in inflationary expectations in that environment. Because the restraint is being undone in other areas, we could at some point begin to get more upward pressures on prices and maybe a little real GNP, but not as much as many think is potential. It would be reflected more in the price element than in nominal GNP somewhere in the fourth quarter or in the first or second quarter of next year; that wouldn't be terribly inconsistent with the strong money growth that we have had, assuming that continues for a couple of months ahead. But all that is predicated on very weak productivity growth and attitudes in the labor market that would say the present rate of unemployment is something like the natural rate, plus an effort to push the economy beyond what its productivity would permit.

MR. BOEHNE. On the economy, the mood in my part of the country is better than in Bob's, but I think that has to do more with the regional comeback than with anything of national significance. There are an awful lot of [help] wanted ads or signs in the windows about jobs available, but I don't see any boom. Again, I don't attach a great deal of national significance to this, because I think it is just a regional correction from the kinds of things that we saw in the other direction in the 1970s.

CHAIRMAN VOLCKER. There is a lot of evidence that the Northeast is doing better than other areas of the country.

MR. RICE. Could I just ask Steve a question? Do you think there are good reasons for expecting that a slight decline in interest rates would stimulate the economy significantly?

MR. AXILROD. I don't know that a slight--

MR. RICE. Well, within a range of 1/2 to 3/4 of a point.

MR. AXILROD. Well, I would think that if short rates came down 1/2 point or so with some definiteness, in the short run the long rates could come down. It would be helpful in the mortgage market and would probably be on the stimulative side. Whether it would be sufficient to get more than 1/4 or 1/2 point on real GNP over time, I don't know, but it is certainly in that direction.

MR. RICE. My guess is it wouldn't.

MR. MARTIN. Well, Mr. Chairman, I don't have a very positive scenario. I think the staff work was careful and conservative. It seems to me that if you look at the sectors in which they are picking up that increase in real growth from 1.7 or 1.5 percent--or whatever the revised figure is going to turn out to be--to 3.0 percent, you get federal spending, residential spending, inventory change, a bit of business fixed in the producer durable equipment area, and a little increase in consumption. But as I look at those categories and think of the downside risk in most of them, it seems to me that it is not too much like Cassandra to look at the chance of a recession. I will take the other end of the spectrum from Steve. Certainly, we have the imbalances in this expansion. They are not the usual imbalances that we are used to: it isn't capacity utilization pressing against a threshold; it isn't rising interest rates. But goodness knows, there are imbalances: the foreign trade side, the farm situation, and all the rest of them we know about. I think that the mortgage backed security market is extremely vulnerable, and that is an $80 billion a year market. On the federal spending side, could we have a real cutback there or a real expansion for that matter? I think neither. The procurement criticisms, the resignation of one procurement officer, and the hearings in the Congress are all constraints on Weinberger and company. So it is quite unlikely, even if they wanted to, that they could give a big push to the economy by saying they have all of this [spending] authority, now let's spend it. Nor is it likely, given the philosophical [mind] set of Mr. Weinberger and his boss, that there would be the opposite--a real cutback in that area. So that's probably a small contribution on the plus side.

We have spoken of the consumer. Employment is still going up a little, unlike the Europeans. The debt burden looks like it has adjusted a little. With tax refunds coming in, those credit card credits have dropped a little, so maybe the debt burden can be handled. In the residential area, I think we are very vulnerable in our forecast. Jim, this will come as absolutely no surprise to you: I think the talk about a 16 percent spurt in residential spending is overly optimistic. It might be half that. That's a couple percentage points off the growth increment maybe. I already made a comment with regard to the importance of the fixed rate mortgage, but there are the TICOR mortgage-backed security losses and private mortgage insurance companies are already talking about $50 to $100 [billion] in loss exposure. I don't know whether the Swiss reinsurance process is going to work here; it has never been tested in this particular kind of insurance. I don't know whether REITs, as they are called, will come in and make the settlements and back up the private mortgage insurance companies so that you can get that $80 billion continuing as funding for the residential spending.

MR. PARTEE. They won't do it willingly, that's for sure.

MR. MARTIN. No, they won't do it willingly--not when you are talking $50 million at a clip per company. So I think there is a real exposure there. As for inventories, goodness, what swings there are: We can get a $50 million help or we can get a $50 million hurt. The inventory situation is puzzling all of us, in terms of its swings. It could help or not. So it seems to me that there are vulnerabilities with regard to the very careful forecast of Jim and his associates for an increase up to 3 percent real GNP. The risks are on the down side in every one of those areas and in other areas that we all know about. The risk of recession, though, seems to turn on some kind of systemic financial--well, not collapse--but real troubles that are hard to handle. I'm talking not just about the ag banks and the thrifts and all of the things that we have talked about so many times, but systemic--[all] financial institutions [unintelligible] private mortgage insurance companies don't pay. And the mortgage-backed securities side of the market--I am stretching to get the biggest figure I can--may be in the widest sense a $350 billion market. I don't think that is the most probable occurrence, but the risks are on the down side. We need to keep those in mind as we set policy.

MR. MORRIS. Do you also have double counting in the mortgage backed securities in the debt number?

MR. KICHLINE. No. Mortgage pools are not in the domestic nonfinancial debt aggregate. The mortgages themselves--that is, the mortgage originations--are.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I normally have a fairly optimistic outlook on most things in life, but I must say at the moment that it has been damped somewhat. In our area of the country there has been a great deal of discussion about agriculture and what may happen. At the moment, as I think most of you know, we will have an outstanding wheat harvest and the prediction on corn, soy beans, sorghum, and so forth is very, very good. On the other hand, there already has been a 20 to 25 percent drop in prices for those commodities; for each of them the price is now below the break-even point for production. At the same time, red meat prices, hogs and cattle, have dropped roughly 20 to 25 percent over the last 60 days. And those producers now are either at a break-even or a loss position. The energy problem somebody has mentioned--the rig count is indeed down by 25 percent from a year ago, but it is flat or going on down in Oklahoma, Wyoming, and Colorado. Mining is flat on its back. Aircraft sales, which are a fairly large component of the output in the Tenth District are flat--flat being no sales at all unless to the military. As a result, there is not a great deal of happiness outside of the metropolitan areas, where economic activity is still going fairly strong in terms of auto production and other activity.

Let me say further that I take no comfort in the budget resolution that has been passed by Congress, because if you look at the history of what has happened in this so-called new budget environment, the budget resolution has not meant very much in the past. Indeed this time, if you look at the agricultural sector, whether you like it or not, the government is going to end up with about 2/3 of all of the production this year as a result of the sign-ups for CCC; the producers simply are going to walk away because the target prices are higher than the commodity price in the market. And that all is a direct tap on the Treasury.

MR. PARTEE. Is that a potentially big number?

MR. GUFFEY. That's a very big number--somewhere in the $24 to $30 billion range. It is something like $18 billion above what otherwise would have been projected. So in my own view, the budget deficit problem is far from resolution and it is going to get worse rather than better. It seems to me that with respect to monetary policy, we have one of two choices. One is in some way to get real interest rates down, which will help marginally in agriculture and some of these areas; and to me the only lever we have to pull is lower [nominal] interest rates and that implies monetization of the debt. As a result I am gloomy and not very optimistic.

CHAIRMAN VOLCKER. It doesn't sound like a highly inflationary report.

MR. GUFFEY. Not with farm commodity prices dropping.

CHAIRMAN VOLCKER. What do you sense land prices are doing now? I was talking to some farmers the other day who claimed that they were going down faster, if anything.

MR. GUFFEY. Well, it is very difficult to tell what land prices are doing simply because there are foreclosures but there are no sales. And as a result, you can get the survey--as we do and I think Minneapolis and Chicago do--and it shows that they are still declining. But those are numbers that are not based upon sales. The amount of land now being held by the Farm Credit Bureau is large. The numbers that I know come out of Wichita and Omaha and they are very large numbers. Most of the agricultural banks that have been deeply involved, and indeed are in trouble, are holding considerable amounts of real estate and simply have hired somebody to try to farm it because they can't sell it. The question, I guess, involves not only the gloom that already has spread, but there is a systemic problem in the financial area that evolves out of the agricultural banking problems that I think is very great.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I am certainly in no way disagreeing with Jim's forecast and there really is very little I can add to previous reports that I have given at other meetings. Weak sectors in the Midwest are continuing to be very weak, with no particular signs of improvement. And I think at this point some of these very heavy industries really won't experience a significant change this cycle. But offsetting that, those parts of the economy that have been doing better continue to do well, and from that perspective the current outlook is pretty good. In autos, for example, the people I've talked to say that despite some aberrations in the current numbers, the underlying demand continues to be pretty good. Construction activity is relatively strong and consumer spending seems to be okay. But perhaps for emphasis, I would echo Roger's comments about the agricultural situation. Land values as we look at them continue to decline. In Iowa, for example, in a statistical sense land values are down almost 30 percent from last year and some 45 percent from the peak. I agree with Roger that this is a statistical look at land values; the transactions that are occurring, are in fact [at prices that are] substantially under that. And given the pressure on commodity prices, I would think that land values are going to continue to come down. Whereas in the past we have had the view that this is all containable and not systemic, I do think it is beginning to back up--both from the banking sector as well as from the farm credit situation. In sum, with the passage of time and with continued deterioration, it begins to take on some systemic implications.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, in the Southeast we continue to experience some moderation in the economic growth. I think what is happening there is basically an adjustment to a less boom-like atmosphere than we had previously. While there are some areas of weakness, I think the strengths in our local economy outweigh those weaknesses at the present time. Louisiana is clearly a very weak area at the moment because of the energy sector, agriculture, and nonresidential building. And while nonresidential building is continuing in the rest of the District, it is a source of concern; I think the absorption rates are not going to be good enough to take this glut of office space that we are getting in most cities of the Southeast, and I think that is going to catch up with builders and financial institutions before too much longer. The recent decline in the dollar has given some hope to the textile and apparel people, although I think most of them realize that it is going to take quite a long time before they feel any particular impact from that. Just a parenthetical observation: I have been very, very surprised at the strength of the protectionist sentiment that I am hearing around the District. In fact, it is not really just from around the District. For example, I had a meeting with the board of directors of a local corporation that has directors from all over the country and the virulence of the protectionist sentiment and the anti-Japanese sentiment was really remarkable to me. I thought we were back in World War II. If this is true around the country, when Congress returns I think we are going to hear a good deal more about this.

The virulence and the "them against us" sentiment was really quite remarkable. I had no idea it was that strong.

As I look at the economy as a whole, I guess I would revise my forecast down somewhat, although basically I would agree with the Greenbook forecast both for the rest of 1985 and for 1986. My concerns would be that the dangers are on the down side. I think we might be lucky if we get 3 percent growth. And I say that because I am not very sanguine about consumer spending. Given the level of consumer debt and the lower personal income that has come in, I am not so sure that the consumer--although consumer confidence appears to be high--is going to spend at quite the levels that the forecast implies. I am also not so sure about the inventory buildup. I think that there is a feeling among many people that they don't have to build their inventories because of the [excess] capacity that we have in the system--that production times are lower and, therefore, they don't have to have as much inventory. Also, I think the uncertainties about the economy are causing some people to reconsider their inventory buildup. So given all of that, Mr. Chairman, I too am not terribly optimistic, although I don't fear a recession. And people I have talked to don't fear a recession, but nobody that I have talked to sees any particular boom for the rest of the year and nobody sees any greater danger of inflation either. So in terms of monetary policy, we are in the usual dilemma in light of the sluggishness of the economy and the growth of the money supply. My hunch would be that we ought to stay about where we are; I will talk about that a little more later when we get to the specifications.

CHAIRMAN VOLCKER. Any other comments?

MR. MELZER. I don't have anything to add on the regional side other than to say that in June we had an increase in manufacturing employment at a 2 percent annual rate, which was an encouraging sign. But some of the other indicators are flat to down.

One comment I would make is that I appreciate the risks on the down side in the forecast as well, but I think there really is something to be said in terms of addressing the long-term imbalances in the economy arising out of the trade deficit and a moderate rate of growth at this period of time. I know that has implications for how the budget deficits are ultimately financed, but I think in the longer term enduring a lower rate of growth for a period of time could be very constructive in terms of addressing some of these imbalances.

CHAIRMAN VOLCKER. Enduring what, these slower rates?

MR. RICE. Lower rates.

MR. MELZER. Yes.

MR. WALLICH. I have very little to add but maybe a little balance on the up side. The case for a resumption of growth at any rate of speed certainly has diminished. Still, I think the predominant view outside this room is that [the expansion] will accelerate a little to the 3 percent--and some people think more--range. I don't think anybody is concerned about a cumulative downturn that in retrospect, if we hadn't done anything, would have required us to take immediate stimulative action. Even if the economy weakens a little further and then turns around, it would be a great mistake to have done a great deal and found ourselves having to backtrack. So I'd exclude from my thinking doing something expansionary. Now, on the expectation of a stronger economy, I think we have something to look forward to in the longer run as the main cause of our troubles. I think as the trade deficit begins to mend--at first stabilizes and then, God willing, is very substantially diminished--that that will have some expectational effects, though nothing very decisive in the short run. But in regard to the possibility of an acceleration, which doesn't seem to be fitting very well into this conversation, the danger that it will run too far I think is also not very great because we have enough leeway. In my view we are well above the natural rate of unemployment and if it were to happen that the economy speeded up, we could accept that for awhile. But that is evidently not the main risk that is being discussed here. I just want to argue that the risk of a significant slowing seems not very strong and the consequences of falsely assessing that seem to be quite great.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, in order to counterbalance you, Henry, I guess I would have to say that I think the possibilities of a recession are distinctly there now. The way I would visualize it occurring is that we have had enough sapping of the strength of the economy through the net imports, which I don't think will level off in the immediate future, that income growth will slow to very little. The saving rate is as low as it can get. The best forecast the staff can give us is for really very little final demand. And with that very small final demand, I think the credit system will start to unwind. We have this disaster awaiting us in income properties and it is getting closer every month than it was the month before. In addition, as the Chairman and others have pointed out, in the last two years the equity buy-backs and mergers and so forth have added to debt, and [firms] just have to have increased revenue in order to support those quantities of debt. Without the increased revenue that is associated with rising sales, we are going to have more and more trouble in that category of finance also. And the farm credit situation is so bad that it is really hard to see what could happen now that would do other than get us into a crisis. I realize that this is a very quiet period, but that is just because the fall has not come and these notes have not come due yet. When they do, there are going to be very few people who are going to have any money to service their debt. I think the fundamental source of [the problem] is the imbalance caused by the import situation, but where [the crisis] is going to occur, if it does occur, will be in the credit area as we get into the fall and winter--in the credit quality problems that the economy now faces. I don't know that there is anything much that policy can do about it. Indeed, it might be a mistake to follow strongly with expansion to try to deal with it because I think the ultimate result of that would be more inflation in the country. And I guess I have a little streak of monetarism in me too, or at least I do believe that in the long run money matters and that if you get a lot of money out there, sooner or later it is going to bring inflation. So I say this hesitantly because I don't have a solution to deal with it; but I do think we must recognize that recession is a distinct possibility.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I hate to make this a bias of the Supervision and Regulation Committee, which I think is the way it will look since--

MR. PARTEE. Well, if it is the right bias--

MS. SEGER. --since I am on that Committee with Governor Partee, but I agree that there is a risk of recession. I think the real vulnerability is the financial system; I just don't know what will be the specific trigger to ring the bell there. I don't know whether it will be in farm credit, whether it will be some fallout from what is now going on in Maryland, or whether it will be something more in the mortgage-backed securities area, but my stomach tells me that [the financial system] will be the trigger that will cause the unwinding.

I had a couple of conversations recently with some people about the import situation, since imported cars from Japan are a very big portion of that total number. You might find it interesting that Detroit, at least, does not see any big fall-off in imports. In fact, they are surprised that the Japanese reacted so quickly to the ending of the "gentlemen's agreement" or whatever you care to call it that had been on the books for four years. Apparently, they would have sent more cars over faster but they could not get them on the ships. Now they are [on the ships] and the sales of imports would have been still stronger except for the strike of the car haulers; the import dealers are far more impacted by that than the domestic dealers because they have to get the cars from the ports to the dealer lots. Anyway, I don't see this import issue going away. I see it getting a lot worse. And the "big decline in the dollar" is in terms of weighted averages; if you look at the dollar vis-a-vis the Japanese yen, the decline isn't that much. These people out in the trenches do not expect the Japanese--even if the dollar were to decline further--to quickly adjust the prices of the autos upward. In fact it would not surprise them to see the Japanese cut car prices to get a much bigger chunk of our market. That did not make me feel terribly good. I don't care what the theory is, but what may go on in a business strategy sense is very, very key to this in my judgment. Also, a couple of people I talked with are in the process of cutting their total sales expectations figure. Before, they had a decline of 300,000 units between the expectations for 1985 and for 1986; I don't know what they will come out with when they get through the revision process. This is something that already is a big drag on the economy and I think it is going to get worse. Maybe I am just being a parochial Midwesterner, but I think that this is a really significant sapping of economic strength, and when the foundation gets termites in it the house eventually feels it. So, that is my concern, and I do think that lower interest rates help in these particular situations.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I don't think there is any doubt that we have a sluggish economy on our hands but nevertheless one that is continuing to grow. I think the sluggishness is due to the imbalances that we all have been discussing, and those stem in large measure from the foreign trade situation. I am not sure there is very much that monetary policy can do about that. As best I can judge the situation in our District, this rather sluggish pattern is likely to continue because the sectors or areas that are doing well are continuing to do well and those that are in trouble are going to remain in trouble. I think we are kind of stuck here without a lot of good options. If I take the Greenbook forecast as a starting point, the one question I have about the outlook is the inventory situation, in part for some of the reasons that Bob Forrestal mentioned but also in part because I don't know what it means when we are satisfying as much final demand as we are from abroad and what that means for domestic inventory accumulation. I have a concern that maybe it means that more inventory is going to get held abroad relative to what one would expect otherwise and that that is going to filter into domestic production and domestic inventory levels in a conservative way.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I really don't have much to add to what has already been said. I don't see a high risk of recession over the forecast period, but I agree with the views that have been expressed that the risks to the forecast are on the down side. I think the probability that we will be able to see 3 percent real growth in the second half is probably less than 50 percent. And I think the rate of growth we get in the second half will not be satisfactory. But just as I see nothing to encourage me to believe that we are going to get some significant acceleration, I don't see anything that is going to push us into recession; I think we are just going to bump along with slow growth. And I agree with Chuck that there is probably very little that monetary policy can do about that at the present time without making things worse.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Well, I feel as comfortable with the forecast in the Greenbook as I can feel, and I don't at the moment see a recession looming immediately in front of us. In terms of developments in the last 6 or 8 weeks, the thing in the economy that probably has surprised me most is housing. I certainly did expect that we would see a little more spark there than we have seen, which led me to believe that maybe this rise in delinquency rates that we have seen in the home mortgage sector was telling us something. But even that doesn't seem to hold up because, for example, on closer inspection we find that the delinquency rates are higher in the Northeast than they are in the South and the West, even though the reverse pattern seems to apply in terms of where the housing shortages are versus the surpluses. So I am at a complete loss to rationalize that. More generally, I sense a much more acute dilemma growing out of the dollar situation than a number of the comments around the table would seem to imply. For one thing, barring a recession in the United States, which would obviously raise havoc with the LDC situation, I see more risk in the possibility of some kind of sudden tumble in the exchange rate, notwithstanding all that the exchange rate implies in the current situation for the trade account. But more importantly, when you look through the exchange rate situation and the trade account, barring that precipitous drop in the exchange rate that would create its own problems, it seems to me that we are looking at a quite real possibility for at least a couple--or maybe even three, four, or five--years of having trade and current account deficits of $100 billion, which in turn--

CHAIRMAN VOLCKER. To be optimistic.

VICE CHAIRMAN CORRIGAN. I think that's probably right.

As a matter of fact, we did an exercise that suggested that even if the exchange rate fell 25 percent over the next two years from where it is now, the current account and trade deficit would tend only to stabilize at around $100 billion. I might add that that was with faster growth in the industrialized countries than is now being projected. But regardless of what number you put on it, the fact of the matter is that any kind of scenario like that implies clearly a willingness on the part of foreigners to continue to accumulate dollar-denominated assets at a pretty rapid rate. And as far out in the future as we considered, it also implies that foreigners are going to be continuing to finance a big chunk of our budgetary deficit. So that situation in itself has worked itself into a classic Catch-22 problem that, in my judgment, aggravates the policy dilemma to a very considerable degree.

Now, I would associate myself with the comments that Martha and Chuck made on the financial situation. I too cannot quite shake the feeling that something, someplace there could pop in an unfortunate way at any moment. But there too what to do about that from a policy perspective is not at all clear. One could make an argument that the whole situation, notwithstanding the problems in the economy and the problems on the international side, could point more easily in the opposite direction from a policy perspective than what the economy itself would say.

You raised a question, Mr. Chairman, about this energy situation. Just by way of a quick anecdote: told me the other day that when they had to bail out that energy bank up in this spring, in the process they acquired some oil rigs which at that time they valued at about 35 cents on a dollar. They now think they are worth a nickel to a dime on a dollar. Now, is not the universe, but I think that is symptomatic of the general situation. So I can't find much to celebrate about here, to put it mildly. But the policy dilemmas implicit in all of this, I think, are as acute as they have been perhaps for a while.

CHAIRMAN VOLCKER. Maybe we better celebrate with a cup of coffee.

[Coffee break]

CHAIRMAN VOLCKER. I would judge from the comments I heard earlier that there isn't much stomach for dramatic new initiatives at this stage of the game, in terms of our own [policy] behavior. I think that is a correct conclusion. Let me just add a few comments to what was said earlier to summarize and to put some different light on them. I think that we are operating in a worldwide situation and sometimes we focus too much on an uncertain outlook for the domestic economy. What happens over a period of time, I think, is very dependent on a larger setting. Bob Forrestal mentioned being shocked by the protectionist sentiment that he heard. That gives an accurate picture of the extent to which that sentiment has built and may be still building. And we are going to have quite a different economic situation, I suspect, here and around the world over the next year to 18 months, if we have big protectionist legislation in the remainder of this Congressional session. I have felt myself a relative optimist in Washington in believing that this can be held off this year. I don't have any illusions that it can held off next year, if things don't improve. Many many people think that I am unduly optimistic in saying that it can be held off this year; we shall see. My optimism is not based on any great analysis other than such things as the fact that the [Congressional] Committees mainly involved that have to originate the legislation fortunately are tied up in tax reform and so forth. That is a political excuse for fending off some of this; I don't know whether it will hold.

Some reference was made to the dollar this morning. I think this is a very sensitive area. We can all argue that the dollar should be down for the trade balance and in time it may well have to be. But if we achieve that lower dollar in a way that undermines confidence in where we are going, I think we are going to have lots of problems. As Jerry Corrigan said, we depend on that inflow of money to finance the budget and maintain reasonably low interest rates. And when I look ahead, this clearly is the overwhelming threat on the price front. We are going to have to swallow a decline of the dollar over time. But how it comes is going to make a big difference as will how fast it comes--whether it is manageable or not. I don't know whether it is going down, but just to draw a policy implication: It is an interesting conversation when we can talk about whether the dollar has come down very much when it has come down 17 percent or whatever it is in about three months. By any historical standards, except the last three or four years, that is an enormous change in the value of the dollar in that period of time. Of course, it followed a period during which it went up 17 percent, I suppose, in the previous six months. It is a very unstable situation. I have a feeling that we are teetering--that is maybe stating it a little too strongly--but we are beginning to run some risk of a loss of confidence in the area. We have managed a 17 percent decline without, I think, raising a lot of concerns so far on the confidence front. I think we have to be cautious about that. We face the situation in terms of the price front where the prices of commodities--many of which are produced in other countries rather than here and not all of them are down here, I guess, but I can't think of a [unintelligible] one--are just terribly low in terms of historical experience relative to other prices. [They are below the cost of] American production anyway; I don't know whether they are below the cost of foreign production. Some day they probably will have to go up somewhat; but they don't seem to be moving in that direction now. There are deflationary forces in certain contexts of the economy; there is no doubt that the prices of services are still going up. I think this is a long-term problem; we can't cure that in the short run.

I don't have anything to add on all the domestic financial strains that were mentioned by a number of people earlier. I would just report that I think the international debt situation is in a period of some fermentation and if we have a break it could easily come there. It's not that it would put us under any greater economic strain at the moment but it certainly could put us under greater political strain. There is a great deal of restiveness in that area; whether people are going to jump the [unintelligible] and follow the more aggressive interpretations of the Peruvian situation is very much in doubt.

Finally, looking at the growth in industrialized countries, there may be some room for feeling a little better. They have taken some easing measures, largely in response to the weakness of the dollar. I think that is one of the constructive repercussions of the decline in the dollar, but those measures have come pretty late. If you just look at the outlook there, it is hard to build up a great feeling that there is going to be great support for the world economy; it may not be a deterioration but you don't get any sense of great exuberance abroad.

I don't think we ought to get in the mood that these problems are all unsolvable. They are going to take a lot of work, even in the monetary policy area, and in the regulatory area and other areas. Monetary policy has something to do with how it comes out. My interpretation of your views is that this isn't the time for strong new tightening or easing, and I share that view. We have edged insubstantially tighter in this intermeeting period, reflecting primarily the more rapid growth in M1. I think our discussion last time suggested that that would be appropriate. We started out with a notional $350 million borrowing level and never hit it in fact--not always deliberately. As the period went on we became more cautious in the provision of reserves but only slightly so. So, I think something like an unchanged approach would imply $400 million plus on borrowing. I could conceive of a little more substantial tightening if people thought that was appropriate, but I don't know how other people feel about that. So let's proceed and get more precise. I don't have any feelings about these various [draft] directives, not having read them until about 10 minutes ago. I might just say as a preliminary thought that I am not sure these directives--depending on what we do--are very accurate reflections anymore of what we think. We really ought to think about rewriting them in a more basic way, but I don't think we can do that in the next--

MR. PARTEE. We have had a sort of informal desire not to change the directives in the mid-quarter meeting. It will be pretty hard to avoid that.

CHAIRMAN VOLCKER. We will have to change M1. I would like to say that the latest figures that we have on M1 are not terribly different. They don't suggest any [big change] in the M1 estimates. If anything, they are consistent with a less optimistic view--if that is the way to express it. They are slightly stronger but growth is not substantially different from the very high August number we were talking about.

MR. RICE. Mr. Chairman, I would favor moving a little insubstantially in the direction of--I wouldn't say tightening, but of trying to rein in M1 a bit more. The main reason I feel this way is because the credibility of the Federal Reserve and its targeting procedures may well be at stake at some point soon, and I wouldn't like to see us lose that credibility. So, I would like to indicate some perceptible move or effort toward bringing M1 back toward the top of the band by the end of the year. I don't want to do anything substantial, as I said; I just want to indicate that we want M1 to move back. So I would be in favor of doing a little more than alternative B and possibly a little less than alternative C, if that could be done. And I would even be prepared to see borrowing around $500 million. But my main concern would be to show some concern for what has been happening to M1. There is a lot of liquidity out there now and I don't think that a slight rise in interest rates will have any perceptible effect on the economy at this point any more than I feel that a slight decline in interest rates will have any effect on the economy.

MR. BALLES. Mr. Chairman, I pretty much agree with the economic outlook as discussed here earlier. In the West it is essentially flat or down in most traditional areas: mining, manufacturing, and agriculture. Those things that are going well are a number of the service industries, whether financial services or telecommunication, and of course defense is going through somewhat of a boom. But by and large it is hard to see anything that is going to push the economy up with any real vigor and our staff forecast is essentially the same as the Greenbook forecast. I would agree with Jim Kichline that, if anything, the 3 percent real GNP growth in the second half has more risk on the down side than the up side. While I, too, have a streak of monetarism in me, I am prepared to ignore this overshoot of M1 as long as we have this peculiar and unusual, and hopefully not permanent, behavior of M1 in terms of the decline in velocity--whether it is a shift in money demand or different elasticities than we thought existed. I would be prepared to overlook that overshoot because of the risk of possible recession, although I think the risk is more toward sluggish growth. Therefore, all things considered, bottom line I am essentially in agreement with the position you expressed: that this is not the time to make any significant moves, either easing or tightening. I think that alternative B pretty much expresses the sort of policy I would like to see between now and the next meeting, with a borrowing target somewhere in the range that was specified in alternative B of $350 to $450 million, probably centered on $400 million.

MR. KEEHN. My view would be very consistent with Emmett's comments. It does seem that we want to be very careful of what we do. But we have a high trajectory of the aggregates, particularly M1, and I also think that we need to begin to scale down as we come toward the end of the year. So I would end up being in favor of alternative B. I'd also move up the borrowings just very slightly to about the $500 million range, as a way to begin to take these initial steps.

CHAIRMAN VOLCKER. Let me interrupt the flow here because I forgot to get confirmation of the transactions of the domestic Desk. It occurs to me now and I raise it now or I will forget about.

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Black.

MR. BLACK. Mr. Chairman, I am very close to Emmett Rice on this. Even if we are in the midst of a one-time downward shift in M1 velocity such as apparently occurred in 1982-83, or if we have a one or two percentage point drop in the long-term trend of velocity, still I think by any measure that a rate of increase of 11.5 percent since last October has to have provided plenty of financial underpinnings for expansion. I am concerned that we will run into this credibility problem that Emmett outlined very clearly, so I think we ought to take an unequivocal action to try to bring M1 down somewhere near at least the top of its long-term range. Alternative C seems about the right sort of alternative to me. But in addition to selecting this path, it is important that we also think about our methodology a bit, because merely choosing that path doesn't insure that we will hit it. I think that we ought to be prepared to take some kind of action to hit this. The relationship between the level of borrowed reserves and the growth of M1 is very tenuous and we keep getting fooled by that. I think it is going to be exceedingly difficult, if not impossible, to predict that, so I would like to see us insert in our operating instructions to the Desk something a little more explicit. We have provided that actions will be taken in the light of what is happening in the economy, what is happening in the domestic markets, the foreign exchange markets, inflation, and the like. And I would like to pass on firm instructions to Peter that we would raise our borrowed reserve target if we start exceeding that unless the economy shows decided signs of weakening beyond what we now expect. It has been very hard, at least for me anyway, to know what was going to be done once we left this meeting in the way of actions in the intermeeting period. And I would like to see us tighten up those procedures if I can persuade you to do so.

MS. HORN. Well, Mr. Chairman, as seems to be the consensus of this Committee, I don't find any reason to argue for much change today in the way we are conducting policy. So I would come out wanting more of the same, which would be alternative B in my mind. However, I would associate myself with some previous speakers who said, with a background of a pretty reasonable forecast in the Greenbook and a background of quite a bit of liquidity in the economy, that we can't go on at this rate forever. So I would like to suggest that some more insubstantial tightening, as the period progresses and as we see events unfold, might be appropriate. And it might be appropriate--more than accomplishing something substantive in terms of the growth rate of money--just as a small signal to markets that in fact we think it can't go on forever and that we are waiting for the right time to take further action. I suppose that would be reflected in the directive, based on the same kind of language we used the last time--that is, the "would" and "might"--that we would react in the event of higher-than-expected growth and might on the lower side.

MR. MELZER. My view would be very similar to what Governor Rice expressed at the beginning. I think we have an opportunity here possibly to slow down the rate of reserve growth without a substantial impact on rates. I was struck by the fact that banks apparently have been running off some of their term liabilities, the Fed has snugged perhaps imperceptibly here over the last period, reserve growth has slowed down, and yet in terms of the impact on the funds rate really all we washed out probably was an unwarranted expectation that there would be a further cut in the discount rate. We really have not firmed beyond the equilibrium level we thought funds might trade at with a slightly easier borrowing target. I asked Peter before about dealers' positions; they seem to be in pretty good shape. So I think there is an opportunity here possibly to slow down the rate of growth of reserves somewhat and perhaps buy a little more flexibility for the future, particularly against the backdrop of 14 percent money growth expected in August. We don't have a lot of flexibility in terms of credibility in foreign exchange markets and so forth to ease reserve positions without damaging that credibility. So I think there is an opportunity here, as I say, to buy some flexibility for the future without a dramatic impact on rates. I would say that "C" is too dramatic a shift, but I would position myself somewhere between "B" and "C;" perhaps a target of $500 million is about appropriate.

MR. MARTIN. Mr. Chairman, to adhere at this time to an emphasis on the monetary aggregates, which has been [our approach] since 1979 or at least from 1979 to 1982, is not justified by what we know about them or what we can predict in terms of the pattern of change in the aggregates, particularly in M1. Well, let me correct myself: the narrow aggregate is still behaving in a pattern outside the modeling of projections plus or minus some standard error. I think there is increasing merit to the thesis that there has been a shift in the demand curve. It seems to me that there's a cumulative effect on the public of financial crises in state after state and in type of institution after type of institution. I am not just talking about Ohio and Maryland and thrifts in California and industrial loan companies in Utah and institutions in Texas and so forth; I'm thinking of the cumulative effect on the public's consciousness of this constant news about failed financial institutions following a multi-decade period in which nobody failed. Take Chicago--pardon me Silas--where the two biggest S&Ls and the two biggest banks, the four dominant financial institutions there, are on sufferance. There's Bank of America, Seafirst, Financial Corporation of America, Texas Commerce--you could go on and on. [There are problem] maritime loans, energy loans, and now real estate loans.

I think we will see more evidence as time goes by that there has been a shift in the demand curve. And for us now to gear our policies around bringing M1 down simply is not warranted given the extreme degree of uncertainty. So I would not support any move which would raise interest rates at this time. Think of the leverage--I use the term badly--that interest rates have in the foreign exchange markets, in less developed countries, in debt coverage servicing, and on and on. While we should not dismiss M1 entirely, of course, we don't know [what drives] M1 at this time. Eventually we will; <u>ex post</u> we will look back on this period and say it was quite obvious that X, Y, and Z were the reasons why M1 behaved in the way it did. So, do we lose credibility if we continue to treat M1 the way we have? No one knows. But we have a Chairman who communicates pretty well with the financial community. After all, we have sublimated or at least set aside to some degree the narrow aggregate to date; we have two other aggregates and we have the debt number and other measures; and we have an able spokesman here. What I am trying to say here is to some extent heresy and that is that I think in this six-week period we should concentrate more on the fed funds rate in the execution of policy. I would mean by that that we would keep the rate exactly where it is now. We would not let it drift up or push it up as some have advocated. I believe we can maintain credibility by maintaining the rate. While I would go for "B," I would hope that in the implementation by the Chairman and the staff that we would keep rates relatively stable. I think stable interest rates might be a contribution to this short-run period. We have heard of stable rates; we have experienced those--it is hard to remember--and I think that might add to our credibility and to some measure of stability in an unstable world. It might even add stability to the decline, and hopefully the gradual decline, in the dollar. I would hope in that regard, Mr. Chairman, that in the [wording of the directive] we would move the [reference to] foreign exchange markets up in position and/or have language indicating that we are paying considerably more attention to that part of the directive.

CHAIRMAN VOLCKER. Just in the interest of clarity, where do you interpret the federal funds rate to be?

MR. MARTIN. Well, I was going by the report of our Staff Director who said 7-5/8, 7-3/4, 8 percent. I would hope that the Chairman wouldn't see fit to go above 8 percent, and I would think that would be consistent with about $350 to $450 million in borrowing and whatever excess reserve path goes along with a cap of 8 percent. I wouldn't want to see 8 percent in the directive but I would hope--failing some gyration in the dollar, which I think is the thing that would be a more important factor now--that we could keep it at 8 percent to 7-1/2 percent.

CHAIRMAN VOLCKER. Having had this strong endorsement of M1, I think it is appropriate that we turn to Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I agree with everything that Governor Martin said. The outlook is extremely uncertain. I don't think there is very considerable risk of a recession developing, but I think there is a considerable risk of a sub-optimal [economic] growth rate, more of the same that we have had in the first half. And it seems to me that there is no need for even a moderate upward movement in interest rates until we have some conviction that the economy really is strengthening, and I don't see that in the numbers yet. I see it in the forecast, but I don't see it anywhere else. As to this credibility issue, it seems to me that if we were in a position where the credibility of the Federal Reserve was rather shaky, one could make a case for moving--despite the uncertainty about the economic outlook--simply because a loss of credibility would have very important consequences in the foreign exchange market, for example. But I don't see that as I observe the foreign exchange market. I don't see participants in that market worried about the Federal Reserve following inflationary monetary policies. So I don't see that there is a need, in order to maintain our credibility, to do something that we don't think necessarily has to be done because of the state of the economy. So it seems to me that a stand-pat policy is an appropriate policy here.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, Governor Martin made my speech for me as well. Given the state of the economy--the sluggish nature of what is going on and an outlook not all that marvelous--I think money market conditions are about where they should be. I don't really see any case for tightening except if one wanted to concentrate on the narrow money supply. I think that would only exacerbate the trade problem. Equally, I don't see a great need for any significant easing. I would be a little concerned about the effect of any appreciable easing on the foreign exchange market. The dollar needs to come down but, as you indicated earlier, a free-fall is certainly not what we want. Given all of those factors and all of the uncertainties that we have in the markets, I would think that staying where we are is right. And if that means letting M1 run over the target, I think we just have to let that happen and explain it as best we can. So, I would opt for a stand-pat policy, and that to me translates into alternative B with a directive that would be asymmetric leaning toward alternative A. I think the borrowing level of $350 to $450 million, centering around $400 million, is about right.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, this certainly is a time that separates the sheep from the goats! I am not enough of a monetarist to be able to bring myself to do something because of the behavior of the monetary numbers that has absolutely no confirmation in the real economy or in the outlook for the real economy as we can see it. Indeed, I would be in favor of easing if it were not for the monetary aggregates--

MR. RICE. So would I.

MR. BLACK(?). I would too.

MR. PARTEE. --because I think we are going through a very difficult period in which a little ease in rates might not hurt. It might be pushing on a string and it might not accomplish too much, but it certainly would not hurt. I am also quite bothered by the foreign exchange market. I think that Jerry and Paul are right: that we could get quite a drop in that. And I suppose a material move toward easier rates would increase the odds that that would be true. I think also that there is a little question about the credibility of the Federal Reserve developing out there. I have seen quite a few reports and heard from quite a few people who say: "Well, we don't see any inflation immediately but you really are setting the stage for it--you are providing all of the liquidity--and we think the result of this is going to be inflationary in the long run."

MR. MORRIS. It is not showing up in the bond market or the foreign exchange market.

MR. PARTEE. I think it's showing up in the foreign exchange market and I think it's showing up a little in the precious metals market. And I believe that is something that we have to be somewhat concerned about. But, as I said, I just cannot bring myself to tighten interest rates--to be specific about what tightening means--on account of this behavior in M1. Therefore, I guess I am stuck pretty much where the Chairman was, except I would sort of like to see the funds rate drift back to about 7-1/2 percent, where it was when we started out, rather than see it cruise along in the high 7s--at 7-3/4 to 8 percent. I think there probably has been a little questioning out there in the market as to whether these numbers mean that there has been some [slight] tightening that has been planned by the Federal Reserve, so I guess that would mean that I would lean toward the low side on this range of borrowings. A $500 million level certainly seems too high to me; $350 to $400 million I think would probably do it and I hope that M1 comes back [within its range]. That certainly is not a plan to bring M1 back; that's a hope that M1 will come back while we continue what is, in market terms, an unchanged policy.

MR. BOEHNE. Well, I feel most comfortable with staying where we are with alternative B--not because I think it is the right place to be, but because I just feel uncomfortable about either tightening or loosening. The more interesting question, as we go past the initial couple of weeks after this meeting, is: What kinds of circumstances would cause one to want to change that to either tightening or loosening? Someone earlier brought up the point that we ought to harden up the procedures. I don't see how we can do that. I think that we are just in a highly judgmental period. However, my own bias is that we ought to have a significant burden of proof [before moving] in either direction at this point. I would go into the period with pretty much an open mind--a symmetrical mindset as far as the directive goes. I could foresee circumstances in which loosening would be the better way or, conceivably, tightening, but I don't think we can nail down those procedures in any meaningful way. But I would not want to see a substantial change in reserve provision unless there were some really pretty good reasons and not just somewhat marginal changes.

CHAIRMAN VOLCKER. Governor Wallich. No, Mr. Stern first.

MR. STERN. I would favor alternative B with a slight tilt toward alternative C; that, in my mind, is associated with borrowing of perhaps $400 to $500 million. This credibility issue seems to me to be a troublesome one because in the abstract it can cut both ways. There are risks in ignoring M1 and there are also risks in reacting to an aggregate whose behavior we don't seem to understand very well. At least in my mind the foreign exchange market is perhaps decisive at this juncture and it seems to be expressing some doubts about the kind of disciplined policy that is being pursued in this country. Largely for that reason I would tilt in the direction of "C," as I indicated.

CHAIRMAN VOLCKER. Okay, Governor Wallich.

MR. WALLICH. I would not want to see a great change in policy. I would like to lean toward the harder side just to demonstrate our good faith with having rebased and then set a new range. I agree that M1 is very dubious; I think there has been a demand curve change. Nevertheless, I think credibility is an objective fact. It's not what people think; it's the way they are going to forge expectations and the way they are going to react to other things we do. So there is an investment there and something is at stake. I think "B," if I read the Bluebook correctly, would by the fourth quarter or the end of the year get us back close to the cone. Is that right, Steve?

MR. AXILROD. That's the projection, but the projections have been consistently wrong.

MR. WALLICH. As of now, one could say that we aim to bring M1 back on track by the end of the year. That, I think, is a respectable reaction to the overshooting of a not-very-reliable variable.

MR. PARTEE. It takes a small fourth quarter to do that.

MR. BLACK(?). It sure does; it's moving away.

MR. RICE(?). He doesn't give it a very high probability.

CHAIRMAN VOLCKER. It's his best guess. It has a probability of 10 percent!

MR. WALLICH. I would not invest a great deal in the effort to bring it back. I think there have been a great many challenges from sensible people to our credibility and I would like to establish a record of having tried, without doing any serious damage by doing so. So, I think "B" and going to $500 million with the funds rate where it is now--it could be 8 percent--and the same funds rate range that we have now.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. For reasons I stated before, I'm in the "B" camp with a little tilt toward the "C" camp as well. I think there is something at least at the margin to this credibility question right now, so that reinforces my own thinking. As far as the specifics are concerned, I would have borrowing of $400 to $450 million going perhaps as high as $500 million if we got into trouble on the exchange rate. But barring that, I think $400 to $450 million should do it. I would have a very modest preference--certainly nothing I would go to war about--for specifying the aggregates at 8-1/2 and 6-1/2 percent. But that's symbolic.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I would also look at "B," obviously for all the reasons that have been stated. My tilt--and it would be a very slight tilt--would be toward "C," which would be a very slight increase. I do have concern about the credibility problem; what is happening to M1 is extremely difficult to explain. I think some stability, if you will, in interest rates would not be bad. I start getting a little nervous when I hear words that seem to say that we need to peg the fed funds rate. I get uncomfortable with that. That would not be the objective, but some stability would be good. Borrowings of about $450 million would be all right with me.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I was thinking about the objectives set at the last meeting and the fact that a position of no change in reserve pressure produced borrowing going from $350 million up to about $800 million in one of the maintenance periods and an average above $500 million in the other periods, and short and intermediate rates crept up something in the neighborhood of 35 to 50 basis points, depending upon which series you look at. So, if that is what no change produced, then I guess today I would like to vote for alternative A, which is an easing. My thinking is that maybe an easing position or less pressure on reserves will produce no change in rates, which is what I think is really needed. In fact, I would like to see the recent uptick unwound or undone and the borrowings back to the target mentioned last time. So I guess I will vote for alternative A with a borrowings target of about $300 to $350 million.

CHAIRMAN VOLCKER. Just in the interest of clarity, the decision last time was something like $350 million tilted toward the high side, with the directive saying that we might move higher if the money supply was higher.

MS. SEGER. But I thought it was in the context of some other--

CHAIRMAN VOLCKER. In the context of some other things as well. But the dollar was down and the economy [unintelligible]. Now, we had an odd week in there.

MR. PARTEE. If I understood Mr. Black correctly, we didn't tighten enough, given the aggregates.

MR. BLACK. But I dissented in May because I thought 6 percent was too much; we got twice that much and so--

CHAIRMAN VOLCKER. Mr. Guffey, I guess you're the only one left out.

MR. GUFFEY. That may have been intentional, Mr. Chairman. I think that everything has been said. In my view, we are neutered with regard to policy at the moment.

MR. BLACK. We are neutered?

MR. GUFFEY. We are neutered to the extent that we don't know what is happening in M1 and we don't know what is going to happen to the economy and, as a result, I don't see any reason to change policy. Thus, if "B" represents no change, that's my preference.

CHAIRMAN VOLCKER. I would rather describe it as a well balanced, astute, careful--. We have a great predominance, obviously, for "B" with some shadings as to what that means. Now, in what way should that be tilted? A range of $350 to $500 million encompasses almost everybody's view; that's a wider range than we normally talk about. I want to be ecumenical in this exercise. What are borrowings running this week?

MR. STERNLIGHT. We are using $400 million in the path; it has been averaging, through yesterday, slightly over $500 million.

CHAIRMAN VOLCKER. Where were we last time?

MR. STERNLIGHT. The last full two-week period was $480 million.

CHAIRMAN VOLCKER. Well?

MR. RICE. No change from where we are now.

MR. PARTEE. That's $400 million.

MR. RICE. No, we were a little over--around $500 million.

MR. PARTEE. No, they're targeting $400 million.

CHAIRMAN VOLCKER. That's where you can read it one way or another, depending.

MR. AXILROD. Governor Partee, we have to write down a number, so we wrote down $400 million. But I think, in essence, it has been $350 to $450 million.

MR. PARTEE. Well, my point is that this doesn't say where it happened to have come out; the [issue] isn't where we are now. It's what we were planning, targeting, expecting to do. That is where we are now.

MR. MORRIS. Even if we aren't there.

MR. PARTEE. It's always either above or below.

MR. RICE. Mr. Chairman, I wonder if we could consider some flexibility as we look out, along the lines suggested by Ed Boehne. If growth in the aggregates should slow markedly, we could move toward ease rather promptly. But if they continue to grow at current rates, we could tilt in the other direction.

CHAIRMAN VOLCKER. Well, that's one variable. We would have to define that a little more. Given what we have now on the money supply, it would be awfully hard to get that down over the next three or four weeks to a figure that to many people seems low for the quarter. I guess this doesn't answer your question. It just raises the question of what you mean by weak.

MR. RICE. I would say the rate of growth is weak if it slows to the 8 percent area.

CHAIRMAN VOLCKER. For the quarter?

MR. RICE. For the quarter.

CHAIRMAN VOLCKER. Well, I'm not objecting to what you say, I'm just saying that as a practical matter--

MR. RICE. It's not going to do that.

CHAIRMAN VOLCKER. Well, it might. But we're not going to know until shortly before the next meeting. That doesn't say we shouldn't do it. But since we are going to get a high August, to get down to 8 percent we would have to have--. The projection already is for a lower September. I don't know when we next meet; it's the first of October. It might become apparent along about September 20 unless something very surprising happens. I'm not saying you're wrong; I just wanted--

MR. RICE. Yes, I understand.

CHAIRMAN VOLCKER. If we put it in that kind of number, there is no substantial prospect of easing purely on the M1 number for a month. That may be all right, but I just want to make clear the implication of what you're saying.

MR. PARTEE. We had specified 5 to 6 percent.

VICE CHAIRMAN CORRIGAN. For the quarter, anyway.

CHAIRMAN VOLCKER. The only way it could be different would be if we had a $5 billion drop or something like that right away. It would have to happen in next week's figures. If I were to write down a number, I would say $400 to $500 million, depending upon the aggregates and the dollar. If the economic news clearly weakened, we would have to say that we may go below it. If the money supply remained very strong, or if the combination of a strong money supply and a declining dollar produced a progressive loss of confidence or loss of credibility, if that's the right word--I'm very chary of the credibility argument for all the reasons that have been stated. [We could have] a great increase of credibility with the monetarists in the short run and if the economy plunges into recession or we have a great financial crisis, we will suffer an enormous loss of credibility in a more basic sense.

MR. RICE(?). An insubstantial change, though, is unlikely to do that.

CHAIRMAN VOLCKER. Well, I don't expect that to happen. I think there is something to this credibility issue as appreciated by the markets. Whether or not it's dependent upon M1, I am not so sure. But I think there's something to it. It's not the only factor. It depends upon what's happening to bond prices, the gold price, the dollar, and the economy. Well, I have to get some expression of consensus here. I'd say $400 to $500 million; $450 million is not much different. A lot of people just said $350 to $450 million, a little lower than what we have been running.

MR. MARTIN. How about $350 to $500 million and a funds rate of 7-1/2 to 8 percent?

CHAIRMAN VOLCKER. That $350 to $500 million is a wider band than we have been expressing, but I don't think it's unrealistic. The starting point or the center of gravity is $425 million, if I average the $350 and $500 million.

MR. PARTEE. Well, I wouldn't want to specify the funds rate.

CHAIRMAN VOLCKER. I don't think that Governor Martin is suggesting that; he's thinking that's the center of gravity of the funds rate with this.

MR. MARTIN. I wouldn't want to specify it.

CHAIRMAN VOLCKER. Let me just try that, in the interest of evoking a response. I don't know what the $350 to $500 million means, except where we start. It's kind of an acceptable range within which borrowing would be varied--nothing much different happening from what we have now--depending upon short-term tactics. It says that the number that Mr. Axilrod would write down would be $425 million. If things changed enough so that we deliberately would go above $500 million or below $350 million, it might be a point where we would have an intermeeting consultation anyway.

MR. KEEHN. If, say, M1 in September came in on the low side, the way that Steve suggested in the Bluebook, does that mean that in fact we would move the borrowing down to $350 million, whereas if that expectation does not come to pass--if we have a higher number--we would aim toward the $500 million? Is that the operative translation?

CHAIRMAN VOLCKER. Well, I am afraid I cannot translate it quite that simply. You have to tell me some other things that are going to happen too. It would certainly go in that direction, if you were just looking at M1. But, if you were telling me that M1 growth was going down at the same time housing starts were coming in at 2 million a year and leading indicators were shooting up and everybody was feeling ebullient about the economy, it might or might not.

MR. KEEHN. I was assuming all other things might be equal.

CHAIRMAN VOLCKER. All other things equal, I would tend to agree with you. But if the economy looked as sluggish as it did and all the rest--. I would also remind you: We have worried about the dollar falling in an atmosphere of lack of confidence, but if the dollar for some reason were very strong in this period--I don't think we expect that--that would be a factor I'd put certainly on the side of taking my chances with M1. It wouldn't be an atmosphere suggesting lack of confidence and credibility and all of the rest.

MR. MORRIS. Did we contemplate buying foreign [currencies] in a situation when the dollar is rising?

CHAIRMAN VOLCKER. Well, if it rose exceptionally I would. I'm not [sure] the Treasury would even though it would seem to make lots of sense.

MR. MORRIS(?). Has anyone talked to the Treasury in that forward-looking sense?

CHAIRMAN VOLCKER. I have not found that terribly productive but I think if that happened, the question would be raised.

MR. KEEHN. Hearing the way you described that range, certainly from my point of view that would be an acceptable approach.

CHAIRMAN VOLCKER. Anyone else like to respond to that?

MR. RICE. Well, the range is fine; the midpoint is not.

CHAIRMAN VOLCKER. You want an assymmetrical midpoint.

MR. PARTEE. The midpoint being $425 million?

MR. RICE. The midpoint being $425 million.

MR. PARTEE. It is a little high.

MR. RICE. A little low.

MR. MARTIN. It must be about right!

CHAIRMAN VOLCKER. That is what makes a horse race. Well,--

MR. PARTEE. Of course, if something happens: say, the money supply comes in stronger than has been projected or other things happen in the economy, you would expect borrowing to run above that. We are talking about a beginning range, aren't we, for the--

CHAIRMAN VOLCKER. Well, I would interpret this ordinarily as where we are. As I said, we just start at $425 million here. And you are right, within experience. But I guess I would interpret this wide margin as saying that something outside of that--not necessarily [unintelligible] obviously--might be the occasion for a little mid-meeting discussion.

MR. PARTEE. So, unless something pushes it rather strongly in one direction or another, it does become the operating range for the period. It is different than what we have done before.

CHAIRMAN VOLCKER. I think this will be a little different twist. There is some mistake, I guess, to reading this [unintelligible] as you tell me. But I think this is a little different from saying, for instance, $425 million and then raising it a little or [lowering it] without specifying the reasons. Excuse me, did somebody have something to say down there?

MR. GUFFEY. Well, I am a bit puzzled. We are in the middle of August now, and if the projections for the money supply in August are somewhat correct, there would have to be a very dramatic movement it would seem to me from the projected 4 percent in September for us to move off the $425 million.

CHAIRMAN VOLCKER. If you are only looking at the money supply.

MR. GUFFEY. Okay. I am satisfied with the answer then.

MR. BALLES. Mr. Chairman, just to clarify one thing: I am not sure what the Committee feels or what you individually believe about the dollar. My own personal view is that continuation of a gradual unwinding of the dollar from the excessively high value probably would be for the good of the country--just thinking of the import-export situation. I hope that it will continue and that a gradual orderly drop in the dollar would not trigger our moving up toward the upper end of the borrowing range. I'd like to hear what your views are, though.

CHAIRMAN VOLCKER. Well, if I could blink my eyes and wake up tomorrow with a lower dollar and no accompanying change in attitudes [as a result of] that, I might argue that that is a good thing. But that is an impossible scenario. The question is: How do we get a lower dollar if that is what we inevitably have to get over time, without throwing inflation off course, interest rates off course, and without overshooting on the down side, in some short-term sense anyway, and if that would bring more pressure on the industrial sector than we can stand because we are so far behind the eight ball there? And we do have to shift literally--it is going to happen. It's not going to happen in the [unintelligible] but it may happen expectationally and in terms of prospects. What does it come to now, Mr. Truman, with a $150 billion trade deficit--maybe 15 percent of our manufacturing output? If we went from where we are now to balance in two years or three years we wouldn't have the capacity to meet [the export demand] without a lot of inflationary pressures, I am afraid, assuming the economy generally isn't otherwise in recession.

MR. PARTEE. Yes.

MR. TRUMAN. Yes. It depends on how you think capacity would be going otherwise. But it is clear that demand depends on what else is going on.

CHAIRMAN VOLCKER. We are at what [on manufacturing capacity] --roughly 80 percent--if you believe these figures?

MR. TRUMAN. We have done a crude calculation that would suggest on one scenario that, in fact, we would be over 100 percent on the capacity utilization index, if--

CHAIRMAN VOLCKER. That is not going to [happen]. It is another way of saying it is impossible to correct the trade balance in that timeframe. But if we had a set of conditions that went in that direction and put in that kind of potential demand on our capacity, even though we could not meet it in three years, we would have a [difficult] circumstance in the manufacturing sector of the economy in terms of sustainability, inflationary pressures, or whatever. Looking at this more broadly here, we are importing 3 percent or more of the GNP. We are consuming 3 percent more than we are producing. If we correct that, we are going to have to have some period of time when consumption is rising by 3 percent less than GNP. Countries don't find that very easy to do. It means lower real incomes. If productivity were rising by 3 percent a year, which it is not--. Let's be realistic about it; it could be rising by 1 percent a year; so it takes three years' growth of productivity to do that without increases in real income.

MR. PARTEE. On John's question, Paul: I think that is a reasonable question. He was talking about the exchange rate, not the rate of change in the balance of trade.

CHAIRMAN VOLCKER. Well, I got off the question a bit but--

MR. PARTEE. Was it a 4 percent decline since the last meeting?

MR. TRUMAN. A little more than that.

MR. KICHLINE. It was a little over 4 percent.

MR. PARTEE. A little more than that. Is that too much?

CHAIRMAN VOLCKER. It's not too much if it doesn't--

VICE CHAIRMAN CORRIGAN. The problem is that there is a threshold level in there someplace.

CHAIRMAN VOLCKER. Yes. One would hope to get it down as fast as when it first began coming down and get it over with and then have a feeling of greater stability. Could we take another 4 percent [decline]? That depends, really. If people thought we were concerned about 4 percent and concerned about the inflationary impact, we would get a different situation. What I would fear the most is a feeling that we were driving it down, that we were easing policy to drive the dollar down, saying "Let's get this thing going." That, I think, is fraught with danger.

MR. BALLES. Well, I would certainly agree.

CHAIRMAN VOLCKER. The situation with that 4 percent may be that it's the first 10 percent of a 40 percent drop. So long as there is a feeling that it's not getting out of hand, I think--

MR. CROSS. It's very unrealistic, isn't it, to think that we could really have a soft landing that people talk about? Gradually moving the dollar down and having this not generate all kinds of responses that would accelerate it and make it happen in 10 minutes--

CHAIRMAN VOLCKER. That's my problem. We may just have an impossible problem. But to the extent the dollar is declining because people feel genuinely better about let's say, Germany and Japan--. Or it could decline against sterling. Sterling got very low and to the extent that people feel that was overdone and sterling went up, one result would be a decline in the dollar exchange rate. But I don't think that is the kind of thing that sets off great expectational movements in the rate; it is much less likely to. I don't know how to quantify it.

MR. BALLES. Mr. Chairman, I wonder if I could ask Sam to explain a bit further why he thinks that a soft landing for the dollar is a very unrealistic possibility.

MR. CROSS. Well, if you are really talking about a soft landing, a continuing steady decline, it seems to me that all the people who are sitting there holding dollars are going to be influenced by what they see going on. And I think they will either anticipate it continuing or take other steps, and it just won't go like that.

CHAIRMAN VOLCKER. Yes. Just in conceptual terms: If there were a firm feeling in the market that the dollar was going to decline gradually, I assure you it would decline suddenly.

MR. CROSS. It would happen overnight once they--

CHAIRMAN VOLCKER. Now, it might not be the worst thing in the world if it happened--if, as I say, you woke up tomorrow and the dollar was 10 percent lower and people said: "That is the end of it. We are down there now. We have great confidence in the dollar at this lower level." That would be great, but I--

MR. CROSS. It is not going to happen that way.

CHAIRMAN VOLCKER. The question is whether they think the first 10 percent is--

MR. BALLES. It's hard to get from here to there.

MR. CROSS. It is impossible.

VICE CHAIRMAN CORRIGAN. Long before we got any of the benefits on the trade side we would get the financial effects of that kind of sudden drop. It would be very messy.

CHAIRMAN VOLCKER. Oh, it is not even the suddenness. I think we are getting along within limits. If it were sudden and people thought it was over, that's fine. But I don't know how you arrange that particular scenario. What you want is a little constructive uncertainty in the market concerning all the ways it could go.

MR. CROSS. You would have to have it move [down] and go up a little and then sideways and then everybody would wonder [which way] it is going. That is the only way you can get there.

CHAIRMAN VOLCKER. I think we have been pretty lucky so far, that is, with what the dollar has been doing in a very compressed time period. But it is so compressed that markets are not going to forget that this trend is pretty clear and sharp. Even though we may get stability for one week, it may go down 2 percent the next week. So far we have been able to play that quite nicely--again by luck, lots of luck. Whether we can continue that, I don't know; it is the best scenario we could have.

VICE CHAIRMAN CORRIGAN. You get stories even from the Japanese people who theoretically are in longer-term Treasury securities that they have this calibrated down to the tee in terms of what set of expectational circumstances with regard to the decline in the dollar would make them move and move fast.

MS. SEGER. What if today's levels of exchange rates are consistent with still higher deficits in the balance of trade?

CHAIRMAN VOLCKER. That may be, and that is a reason why the dollar has to come down. But that does not tell you how to get there easily. We cannot cure the underlying problem that we are borrowing $150 billion a year abroad.

MR. GUFFEY. Or $200 billion at home.

CHAIRMAN VOLCKER. And that you can't dispense with that without it having other consequences.

MS. SEGER. Well, the American banks would buy government securities and make less consumer loans and tighten up their standards there. Is that all bad?

VICE CHAIRMAN CORRIGAN. And never sell them.

MR. TRUMAN. You'd have less consumption.

CHAIRMAN VOLCKER. Within limits it is probably not all bad. But you are saying tighten up on consumer loans, tighten up on all other kinds of loans. What you are saying is higher interest rates. That is one consequence, I agree.

MR. WALLICH. Well, at this level of capacity utilization what would it do? Three percent of GNP would be about 4 to 5 percent on capacity utilization.

CHAIRMAN VOLCKER. I don't know. You have to look at manufacturing capacity. That is where? You say [85] percent?

MS. SEGER. Well, you have to look industry-by-industry too.

MR. WALLICH. Manufacturing.

CHAIRMAN VOLCKER. Mr. Truman has a subtotal of 100 percent capacity utilization.

MR. TRUMAN. Yes, but that's with no give.

CHAIRMAN VOLCKER. I think that is probably exaggerated a little.

MR. TRUMAN. That is simply the counterpart to your [85] percent.

CHAIRMAN VOLCKER. That's not going to happen that fast. But the tendency, with a sharp enough decline in the dollar, would be in that direction.

VICE CHAIRMAN CORRIGAN. Well, it would have to be more than that because you would have to compensate for the oil imports; you wouldn't be able to stop those.

CHAIRMAN VOLCKER. Well, let us return to an operating decision here. We had a proposal on the table.

MR. PARTEE. $350 to $500 million.

CHAIRMAN VOLCKER. What we are saying in traditional terms is $425 million with a band of flexibility around there that is significant but not huge. It's barely significant, I suppose, in terms of its flexibility. If we got much beyond that, conditions probably would justify some discussion. That, I guess, is fairly obvious.

MR. PARTEE. And the specifications of "B"?

CHAIRMAN VOLCKER. I haven't looked very carefully at these. Has anybody thought or felt some strong predilections? We have a couple of alternatives here. Which alternative do we start with?

MR. RICE. Mr. Corrigan put some specifications on the table.

CHAIRMAN VOLCKER. Well, apart from the specifications, we have some language labeled alternative I and alternative II. Is there any feeling between alternative I and alternative II, apart from what numbers we pick?

MR. PARTEE. Pres does.

CHAIRMAN VOLCKER. Alternative I spotlights the overshoot on M1; that's the substance of the difference in approach. It may be appropriate. Having not read it carefully yet, I will express an opinion that the fact that M1 is kind of out of bounds would lean me toward II just in terms of format, not substance, here.

MR. MARTIN. It seems to me, Mr. Chairman, that alternative II is a somewhat fuller discussion of M1 growth--what we expect and what its implication is--than alternative I.

CHAIRMAN VOLCKER. That's my offhand feeling. Shall we work from alternative II?

MR. PARTEE. Yes.

MR. BALLES. I would prefer it.

MR. FORRESTAL. Yes.

CHAIRMAN VOLCKER. All right. Let's for the moment work from alternative II. I think we are saying "maintain" basically, but that does leave a question in my mind. Either here or in the discussion [in the policy record]--maybe we can do it just in the discussion--we might say that we did have an insubstantial firming.

MR. AXILROD. We would put it in the policy record.

CHAIRMAN VOLCKER. We could say here "maintain the degree of pressure on reserve positions sought in recent weeks" and then explain in the policy record that that is very slightly tighter than when we said maintain last time.

MR. PARTEE. It would be characterized as a little tighter?

CHAIRMAN VOLCKER. I would be very delicate in what words we use. "A somewhat more cautious provision of reserves" I think is about--

MR. AXILROD. It requires extreme delicacy this time since the level of borrowing unfortunately has been dropping as we have gotten slightly tighter.

CHAIRMAN VOLCKER. We would have to explain the aberration in the one week and say we approached it a bit more cautiously. That's enough. Now, what numbers do you want to put in here on M2 and M3?

VICE CHAIRMAN CORRIGAN. I had suggested--

MR. BALLES. 9, 8-1/2 and 6-1/4 percent.

CHAIRMAN VOLCKER. I don't like to use the quarters.

VICE CHAIRMAN CORRIGAN. I had suggested 6-1/2 and 8-1/2 percent.

CHAIRMAN VOLCKER. What did we say last time?

MR. AXILROD. You had 7-1/2 percent last time, Mr. Chairman. And our present estimates are 8-1/2 percent for M2 and 6-1/2 percent for M3, so--

CHAIRMAN VOLCKER. Suppose we said 7 to 8 percent for both of them? One is slightly lower and one is slightly higher but--

VICE CHAIRMAN CORRIGAN. That is fine with me.

MR. MARTIN. Seems reasonable.

CHAIRMAN VOLCKER. Rates of around 7 to 8 percent.

MR. PARTEE. Expecting to miss both of them. An average--

SPEAKER(?). The average guesses.

MR. MARTIN. 8-1/2 percent and 6-1/2 percent.

CHAIRMAN VOLCKER. Well, I don't feel strongly about it but--

MR. BALLES. That 8 percent sounds pretty high for M3, Mr. Chairman. That is above anything shown in the alternatives here.

MR. PARTEE. I'd rather pick 6-1/2 and 8-1/2 percent. I'd take the point estimates. That happens to average to 7-1/2 percent; I don't know that that means anything. Have we ever said that we average the aggregates?

MR. MARTIN. Geometrically or arithmetically!

CHAIRMAN VOLCKER. I would have some preference, or more than a slight preference, for not changing the numbers if we don't have to. That is the only advantage of 7 to 8 percent, but I will not press the point. Would you rather say 7 to 8 percent or 8-1/2 and 6-1/2 percent?

MR. WALLICH. 8-1/2 percent would be good.

MR. MARTIN. 8-1/2 percent.

CHAIRMAN VOLCKER. Well, we'll just be wrong on both.

MR. PARTEE. With a point estimate you don't expect it to be exactly right.

CHAIRMAN VOLCKER. I didn't realize they did when you said--

VICE CHAIRMAN CORRIGAN. You could have lucked out.

MR. AXILROD. I should change my definition of success in projecting, Mr. Chairman, because I always thought within a percentage point was success.

CHAIRMAN VOLCKER. So did I.

MR. BLACK. Even with the period half done.

SPEAKER(?). [Unintelligible] third quarter.

CHAIRMAN VOLCKER. 8-1/2 and 6-1/2 percent. "M1 growth is expected to slow markedly--"

MR. KEEHN. How about that word "markedly"?

MR. MARTIN. Yes. How about omitting it?

MR. PARTEE. Well, it has gone from 14 percent to 4 percent; that's quite a slowing.

MR. KEEHN. Yes, but it is subject to judgment, and people will interpret it one way that may not be appropriate. I'd eliminate it.

CHAIRMAN VOLCKER. Why don't we say "given relatively rapid growth in recent weeks." What number do you want to put in there?

VICE CHAIRMAN CORRIGAN. I'd want to put 8-1/2 percent.

MR. PARTEE. 6 to 10 percent.

CHAIRMAN VOLCKER. Come on! You wanted to put in a precise number on the others.

MR. BALLES. I'd suggest 9 percent.

MR. GUFFEY. How about 7 to 9 percent?

VICE CHAIRMAN CORRIGAN. Let me make the case for this 8-1/2 percent. I don't feel that strongly about it, but the only reason I'm attracted to it is that I think it does lend a little to the point of view that suggests we are not totally indifferent about being outside the tunnel, or whatever the heck we call it, for the second half of the year that we just adopted 6 weeks ago. That's the only thing that leads me to that number as opposed to the 9 percent. But I--

CHAIRMAN VOLCKER. You prefer 8-1/2 percent to the 8 to 9 percent?

VICE CHAIRMAN CORRIGAN. Yes, but I am somewhat agnostic.

CHAIRMAN VOLCKER. Where does the sense of the meeting lie?

MR. MARTIN. That it matters less than it used to.

MR. GUFFEY. If we use the 7 to 9 percent, it is centered on 8 percent but it does give us some flexibility to go one way or the other without having to make any policy move.

CHAIRMAN VOLCKER. The trouble that I see with that is the 7 percent; it is realistically less than most people think it is going to get to, I guess.

MR. BALLES. Well, it should be.

MR. GUFFEY. But to use 7 to 9 percent, centering on 8 percent, seems to me to provide flexibility that would be desirable.

VICE CHAIRMAN CORRIGAN. We need a decline in September to get 7 percent.

MR. MORRIS. Why do we say "relatively rapid growth"? That sounds like it wasn't really very rapid growth at all--that it was sort of rapid growth. And it was a heck of a lot bigger than that.

CHAIRMAN VOLCKER. Well, take out the "relatively."

MR. MORRIS. Yes.

CHAIRMAN VOLCKER. That's acceptable?

MR. PARTEE. "Given the rapid growth in recent weeks" is what we say?

CHAIRMAN VOLCKER. What number do you want to put in?

MR. MARTIN. 9 percent is the expectation, isn't it? Why don't--

MR. FORRESTAL. 9 percent is what I'd like to see.

MR. BALLES. 9 percent is what I want.

MR. RICE. I'd prefer 8-1/2 percent.

MR. WALLICH. I'd like to stick in some way with the range that we set; maybe we can straddle it with 7 to 9 percent.

MR. PARTEE. Well, this is an expectation and not a policy statement. Maybe--

CHAIRMAN VOLCKER. In terms of a policy statement, we'd accept [unintelligible] depending upon what we do and given this uncertainty. It sounds like the right thing is 8 to 9 percent, but I'm not sure. If we have a consensus for 8-1/2 percent, that's fine.

VICE CHAIRMAN CORRIGAN. That's fine.

CHAIRMAN VOLCKER. 8 to 9 percent?

MR. MARTIN. No problems with it.

CHAIRMAN VOLCKER. Now, on this next sentence it strikes me that we don't need that "although" part. It sounds awfully precise.

MR. PARTEE. That's the second next sentence?

CHAIRMAN VOLCKER. Yes.

MR. MARTIN. I'd prefer "might" instead of "would" in the first sentence.

MR. PARTEE. Since that's what we seem to have done, I think that's what we ought to put in.

CHAIRMAN VOLCKER. What do you want to put in? Well, we'll go to the "woulds" and "mights." First of all, forget about the clause at the end; we'll take that up separately. Just on this standard phrase about somewhat greater or somewhat lesser restraint, the issue is: Do we want a sentence like that?

VICE CHAIRMAN CORRIGAN. Yes.

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. In the absence of any objection we will have a sentence like this. Now we have to discuss whether to put in "mights" or "woulds." Is there some expression for "mights"? What's the--

MS. SEGER. It was a "might" and a "would."

MR. KEEHN. It's not a strong preference, but I would prefer "would."

CHAIRMAN VOLCKER. We're just talking about the first sentence.

MR. RICE. On the first sentence?

MR. KEEHN. Right.

MR. MELZER. Didn't we have "would" last time?

CHAIRMAN VOLCKER. I think we did.

MR. MELZER. If the thought is to lean a little firmer this time, I would think we'd stay with "would."

MR. PARTEE. But we didn't do it.

CHAIRMAN VOLCKER. Well, we did it slightly. On this basis too I--

MR. PARTEE. I guess so.

CHAIRMAN VOLCKER. It's not very substantial.

MR. RICE. I'd say "would."

CHAIRMAN VOLCKER. Well, how many opt for "would"?

VICE CHAIRMAN CORRIGAN. I prefer "would."

MR. BERNARD. Six.

CHAIRMAN VOLCKER. How many are for "might"? I suppose 5; I count 4; somebody is not voting.

MR. BERNARD. There are 11 voting members.

CHAIRMAN VOLCKER. Tentatively, we have "would," [not] I guess by an enormous majority. Now, the next sentence. We had "might" last time.

SPEAKER(?). I'd say it should be "would."

CHAIRMAN VOLCKER. Let me propose that we put in a "would" here too but leave out the bottom part.

VICE CHAIRMAN CORRIGAN. Yes, the "although"--

SPEAKER(?). I would support that.

CHAIRMAN VOLCKER. Is the last part of that sentence off?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Somebody suggested that in this next sentence we move up "foreign exchange markets."

MR. MARTIN. Yes. Given its importance today in all markets and the vulnerability of the financial system, I think we should give evidence that we are indeed more concerned about that sector.

CHAIRMAN VOLCKER. How would you do it specifically? I don't disagree with the sentiment, but that's--

VICE CHAIRMAN CORRIGAN. Well, if we really wanted to change it, we could put the reference to the foreign exchange markets in the "somewhat greater restraint" sentence: "somewhat greater restraint would be sought in the event of substantially higher growth of the monetary aggregates in the context of exchange rate developments" or something like that.

MR. MARTIN. If the Chairman had just made a presentation to Congress or a major address on that subject and given a signal, I'd be for putting it up there. But since that has not--

CHAIRMAN VOLCKER. This is the kind of thing I had in mind: I don't know whether we can make this any more substantial and I don't know whether--

MR. PARTEE. These other factors are really quite important: the business expansion, inflation, conditions in domestic credit markets and--

CHAIRMAN VOLCKER. Yes, that's the problem with changing it. In substance, I don't know whether we should do it for the reasons Governor Martin suggested but in a short-term tactical sense it belongs there. But these other things are very important and provide the general background. I guess it would be--

MR. MARTIN. Put it in after "strength of the business expansion" now, and then when you have made such a presentation move it up.

VICE CHAIRMAN CORRIGAN. We may not be able to do it now, but I'll tell you: The more I think about it, it makes a heck of a lot of sense because it also allows us in that context to get back to this damn budget deficit question. That thing is just going out the window on us and, ultimately, that's what is driving the whole conundrum.

MR. PARTEE. Paul, I think we might say simply "the movement of foreign exchange rates" or something like that after "the business expansion." But then the last phrase ought to be revised to say "domestic and international credit markets." We don't want to drop out the international credit markets.

CHAIRMAN VOLCKER. No. "In either case such a change would be considered in the context of appraisals of the strength of the business expansion and--." What's the word: "conditions"?

MR. PARTEE. I said "movements" but--

VICE CHAIRMAN CORRIGAN. "Patterns."

MR. PARTEE. "Developments in foreign exchange markets."

CHAIRMAN VOLCKER. --"developments in foreign exchange markets, progress against inflation and conditions in domestic and international credit markets."

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. "Changes in developments in foreign exchange markets."

MR. AXILROD. Mr. Chairman, I just want to point out that a difference between alternative II and alternative I was that the two sentences are reversed. At the last meeting the lesser restraint sentence was first and the greater restraint sentence was second. In alternative II, I reversed them; I don't know how that will be read by the market or how the Committee would feel about that. Also the words "somewhat greater restraint would be sought" in the previous directive were "would be acceptable," but for better English language I changed that because I used "acceptable" in another sense later on.

CHAIRMAN VOLCKER. Where is this "acceptable"?

MR. AXILROD. Where it now says "somewhat greater restraint would be sought in the event of..." last time it said "would be acceptable in the event of...."

CHAIRMAN VOLCKER. Why don't we leave that.

MR. AXILROD. You're leaving the other out?

CHAIRMAN VOLCKER. Also take it out.

MR. AXILROD. I took it out because I had another "acceptable" in there.

CHAIRMAN VOLCKER. [Unintelligible] acceptable and--

MR. AXILROD. I'm hung up on--

MR. PARTEE. Oh, we just took that out.

MR. AXILROD. Yes, that's right. So you can put the "acceptable" back in. That's what I'm pointing out.

SPEAKER(?). Yes, the "acceptable" we can.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. Do we put the "acceptable" back in?

SEVERAL. Yes.

CHAIRMAN VOLCKER. Does anybody have any other comments or suggestions on the whole package?

MR. GUFFEY. Can you tell me what you've done with that last sentence with respect to the foreign exchange markets?

CHAIRMAN VOLCKER. "In either case such a change would be considered in the context of appraisals of the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets."

MR. FORRESTAL. And the "although" clause in the previous sentence is out?

CHAIRMAN VOLCKER. Out. They are both "woulds" and "acceptable." Well, we're going to vote unless somebody has a--

MR. BLACK. It's 6 to 10 percent, I guess, Mr. Chairman.

CHAIRMAN VOLCKER. 6 to 10 percent at the bottom and borrowing of $425 million, which is about where we are now and with flexibility around there in either direction depending on the money supply and other circumstances.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Black	No
President Forrestal	Yes
President Keehn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	No
Governor Wallich	Yes

CHAIRMAN VOLCKER. We're having a luncheon for Governor Gramley.

END OF MEETING